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Etc.

WORLD FINANCE

1937–1938

By

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LONDON

KEGAN PAUL, TRENCH, TRUBNER & CO., LTD.

BROADWAY HOUSE: 68–74 CARTER LANE, E.C.

First published 1938

Printed in Great Britain by Butler & Tanner Ltd., Frome and London

To MY FATHER

ON THE OCCASION OF HIS

SEVENTIETH BIRTHDAY

PREFACE

THIS book is the third of a series, the first two being *World Finance Since 1914* and *World Finance, 1935–1937*. Having covered some twenty-one years in the first volume and two rather eventful years in the second, I have come to the conclusion that, while current financial history continues to be so full of important and interesting events, it is well worth while to devote a whole volume to each year. Thus, so long as financial conditions remain as unsettled as they have been in recent years I intend to publish a yearly volume in this series—that is, provided that the response justifies my belief that a need exists for a Year Book of this kind.

Admittedly, the admirable publications of the League of Nations provide ample statistical and factual material covering contemporary financial history. These publications are, however, addressed to the expert rather than to the general public. For one thing, the necessity for cramming them with figures and charts, while increasing their value to the specialist who uses them as reference books, does not make them any more readable for the layman who is usually terrified of statistics. Moreover, the official character of the publications precludes the free expression of views and the inclusion of facts other than those officially admitted. Being a private individual, with no official ties, I feel entirely at liberty to criticise any Government, party, class, politician or economist. As the reader will see for himself, I have made full use of this freedom.

While the League of Nations publications have to confine themselves to the official material of facts, or at any rate to the material which, if published, will not give offence to any of the various official quarters concerned, I am at liberty to make use of all the factual material at my disposal, irrespective of its origin or the official attitude towards it. The hitherto unpublished material contained in this volume will, I trust, assist in the understanding of events which, on the basis of the published facts, may have appeared inexplicable.

At the risk of incurring unpopularity, I lay stress upon the efficiency with which the Totalitarian States have conducted their economic affairs amidst great difficulties. Most people

like to believe that their enemies are hopelessly inefficient, and do not like to be told anything that is calculated to unsettle their minds in this respect. In reality, the underestimation of the economic advantages of a disciplinarian system, whatever view one may take of it from other points of view, has already caused much harm and is likely to cause more. It was the view that both Germany and Italy were bound to collapse under the burden of the financing of rearmament that was responsible for the easy-going attitude of the democratic countries, enabling the dictators to rearm undisturbed. Notwithstanding the evidence provided by the experience of recent years, many quarters continue to believe in the coming collapse in Italy and Germany. It is always dangerous to allow the wish to be father to the thought. The sooner those who are in a position to influence public and official opinion realise that Great Britain and the democratic countries can only rely upon their own strength, and not upon their opponents' weakness, the better from the point of view of world peace.

A large part of the volume is devoted to criticism of those responsible for the advent and prolongation of the gold scare. In order to meet possible criticism on the ground that I am jobbing backwards in this respect, it is necessary to point out that my attacks on the gold-scaremongers were published for the most part during the gold scare in my daily "Lombard Street" column in *The Financial News*. In the light of the subsequent trade setback it is now evident to everybody that, had the Governments followed the advice of those who urged them to cut the price of gold, the extent of the setback would have been incomparably greater. The gold-scaremongers themselves must have realised this by now, though hardly any of them have admitted their mistake.

The mismanagement of the franc is also subject to critical comment. It is my contention that, since the depreciation of the franc was inevitable, the French authorities ought to have arranged it according to plan, instead of yielding to the pressure whenever it happened to be too strong, and wasting the gold reserve of the Bank of France in futile attempts to check the fall. In this respect, too, I plead "Not Guilty" to the charge of jobbing backwards, having stated in print time after time, from the very outset, that the devaluation of September 1936 was not nearly sufficient.

On the other hand, I must confess that the trade setback during the autumn of 1937 took me completely by surprise.

In *World Finance, 1935–1937*, I anticipated a prolonged upward trend. Even though at the time of writing the immediate trade outlook appears to be gloomy, I am firmly convinced that, given the fundamental factors, which are making for a rise in prices, the present setback can only be temporary.

In *World Finance, 1935–1937*, I laid stress upon the importance of the repercussions of monetary policy on international politics. Indeed, the management or mismanagement of monetary policy influences the course of history to a much greater extent than is generally realised. The material in the present volume provides many examples of the political influence of monetary policy. The international political position, prestige and attitude of every one of the Great Powers, and of many of the lesser powers, has been affected to an amazing degree, since the war, by their monetary policy or that of another country. The sooner the real importance of this factor is realised, the better. Statesmen can no longer afford to consider monetary policy a matter of technical detail. It is likely to be of decisive importance, not only regarding prosperity or depression but also regarding war or peace, and victory or defeat. The armed strength of a nation depends to a very large extent upon the monetary policy which that nation pursues. The defence of sterling at an overvalued level led to naval disarmament and the Invergordon incident. Had it not been for the suspension of the gold standard in 1931, the mistaken monetary policy pursued since the war might by now have led to the collapse of the British Empire. This and many other lessons of recent financial history are well worth remembering.

E.

THE WHITE COTTAGE,
SOUTH BOLTON GARDENS,
LONDON, S.W.5.
March, 1938.

CONTENTS

CHAP. PAGE

PREFACE vii

PART I

INTRODUCTORY

I A YEAR OF SCARES AND JITTERS . . . 3

1. Changing Sentiments in 1937.—2. A Series of Shocks.—3. Resistance to Reflation.—4. The Rich Men's Revolt.—5. The Psychological Factor.—6. Rehabilitation of Gold.

II SCOPE OF THE BOOK 10

1. Introductory.—2. The Gold Scare.—3. The Tragi-Comedy of the Franc.—4. Armament Finance.—5. War Finance.—6. The Setback in Trade.—7. Gold Rush and Dollar Scare.—8. Minor Scares.—9. The Situation in 1938.—10. Conclusion.

III WORLD FINANCE, 1914–37 16

1. Quarter of Century of Financial Revolution.—2. Repressed Inflation during the War.—3. Uncontrolled Inflation after the War.—4. Chaos and Climax.—5. Stabilisation through Devaluation and Deflation.—6. Surface Stability *v.* Fundamental Disequilibrium.—7. Crisis and Deflation.—8. All-round Devaluation and Reflation.

PART II

THE GOLD SCARE

IV FROM SCARCITY TO ABUNDANCE 25

1. The Unexpected Gold Scare.—2. Was there a Gold Shortage before 1931?—3. Maldistribution of Gold.—4. Palliatives.—5. How Gold Scarcity was Relieved.—6. Writing-up of Gold Stock.—7. Increase of Current Output.—8. New Maldistribution.—9. Gold and Credit.—10. Ample Gold Resources.

V HOW THE GOLD SCARE BEGAN 33

1. Boom-like Developments in 1936–7.—2. The Gold Scare of 1916.—3. The Gold Scare of 1935.—4. Vague Fears about Gold Prospects.—5. President Roosevelt and the Gold Scare of 1937.—6. Soviet Gold Exports.—7. Professor Sprague's Rôle.—8. Effect of Rumours.—9. Gold Scare—A Result of Coincidences.

CHAP. PAGE

VI THE GOLD-SCAREMONGERS 42

1. How the Gold Scare was kept Alive.—2. Rumour-mongering.—3. One-sided and Exaggerated Reports.—4. A False Axiom.—5. Was Increase of Gold Production without Precedent ?—6. Defeatism of Bank for International Settlements.—7. Money Muddle in Sweden.—8. Sprague *v.* Sprague.—9. Cassel *v.* Cassel.—10. Brand *v.* Brand.—11. Mr. Hawtrey's Consistency.

VII THE OFFICIAL ATTITUDE TOWARDS THE GOLD SCARE 53

1. Half-hearted Denials.—2. Loopholes for Scare-mongers.—3. A Deliberate Policy ?—4. Efforts to Rush Governments into Lowering Gold Price.—5. Exchange Equalisation Account's Gold Purchases.—6. A Mistaken Policy.—7. Effect of British Official Attitude upon American Opinion.—8. Criticism in Parliament.—9. Muddling Through.—10. Mr. Keynes's Advice.

VIII THE END OF THE GOLD SCARE 61

1. Effect of the Gold Scare.—2. Why the Gold Scare Ended.—3. Exchange Equalisation Account's Additional £200 Million.—4. Improvement of Technical Position.—5. Disappearance of Original Causes of Gold Scare.—6. Cessation of Boom.

PART III

THE TRAGI-COMEDY OF THE FRANC

IX A MISMANAGED DEVALUATION 69

1. The Franc and World Finance.—2. M. Blum's Mistake.—3. Inadequate Devaluation.—4. Anti-Capitalist Measures.—5. The Rich Men's Revolt.—6. The London Credit.—7. Budgetary Difficulties.—8. The 40-Hour Week and the Trade Balance.—9. M. Auriol's Mistakes.

X THE TRUCE OF MARCH 77

1. M. Blum's Concessions.—2. Re-enter the "200 Families".—3. Further Devaluation Inevitable.—4. Temporary Respite for the Franc.—5. Effect of the Gold Scare.—6. French Dishoarding and Repatriations.

XI EXIT M. VINCENT AURIOL 83

1. End of Respite for Franc.—2. Paris Exhibition Fiasco.—3. MM. Rist and Baudouin Resign.—4. Pressure in Favour of Exchange Restrictions.—5. Negative Attitude of Partners in Tripartite Agreement.—6. The Government asks for Exceptional Powers.—7. M. Caillaux Hits Back.—8. Exit M. Finaly.—9. M. Blum Defeated.

XII ENTER M. BONNET 92

1. Efflux of Gold.—2. The Franc allowed to Depreciate.—3. Fiscal Measures fail to Restore Confidence.—4. Signs of Improvement.—5. Treasury's Unfavourable Position.—6. M. Bonnet's Blunder.—7. Stage-Management of the Franc.

CHAP. PAGE

XIII THE CLIMAX 99

1. Signs of Demoralisation.—2. Mistaken Tactics.—3. Defeatism.—4. Need for Major Depreciation.—5. Political Troubles.—6. Government and Exchange Restrictions.—7. The Climax of October.—8. A Blessing in Disguise.

XIV SURPRISE RECOVERY 107

1. The Rambouillet Declaration.—2. Socialists' Conciliatory Attitude.—3. Recovery of the Franc.—4. Favourable Changes.—5. Repayment of London Credit.

PART IV

REARMAMENT FINANCE

XV REARMAMENT AND MONETARY POLICY . . . 115

1. A Fundamental Factor.—2. Rearmament in Germany and Italy.—3. Rearmament in Great Britain and France.—4. Rearmament in Other Countries.—5. Full Effect of Rearmament Temporarily Neutralised.—6. Rearmament and Fundamental Readjustment.—7. "Money Always Obtainable for Armaments."

XVI FINANCING BRITISH REARMAMENT . . . 120

1. Taxation *v.* Borrowing.—2. Long-term *v.* Short-term Borrowing.—3. Dear-money Influences.—4. Adverse Trend in Gilt-edged Market.—5. Blunder of National Defence Loan Announcement.—6. An Ill-timed Decision.—7. Dear-Money School's Triumph.

XVII MR. CHAMBERLAIN'S BOMBSHELL 127

1. Government and Rearmament Profiteering.—2. The National Defence Contribution.—3. Violent Opposition.—4. Selfish Attitude of Wealthy Classes.—5. Short-sighted Attitude of Socialists.—6. Principles *v.* Details.—7. Machiavellian Motives ?—8. National Defence Contribution Scheme Abandoned.

XVIII REARMAMENT AND THE FRANC 134

1. National Defence *v.* Monetary Stability.—2. France sacrificed Security for the sake of Defending the Franc.—3. M. Blum increases Arms Expenditure.—4. Devaluation and Rearmament.—5. M. Chautemps and National Defence Finance.

XIX DR. SCHACHT'S CONJURING TRICKS . . . 140

1. "Collapse" Predictions fail to Materialise.—2. "Miracle" of Rearmament Finance.—3. No Inflation.—4. "Magic Coin" spent over and over again.—5. Discipline and Stability.—6. Increase of Public Debt.—7. Export Subsidies.—8. Skilful Manipulation of Clearing Agreements.—9. Debtor's Strong Position.—10. Exchange Clearing and Rearmament.—11. Food Shortage.

CHAP. PAGE

XX REARMAMENT AND THE LIRA 150

1. The Pesaro Statement.—2. Flight from the Lira.—3. Inadequate Devaluation.—4. Internal Financing causes no Major Difficulty.—5. Deterioration of Exchange Position.—6. Efforts to Raise Funds Abroad.—7. Liquidation of Foreign Assets.—8. A Second Devaluation ?

PART V

WAR FINANCE

XXI THE SPANISH TRAGEDY 161

1. Financial Origins of the Civil War.—2. How Spain lost her Vast War Profits.—3. Overvaluation of the Peseta.—4. Political Effects of Mistaken Monetary Policy.—5. The "Mañana Standard".—6. Influence of French Monetary Policy.

XXII SPANISH WAR FINANCE 166

1. Moratorium.—2. Payment of External Credits.—3. Bank of Spain's Gold.—4. The War Material Racket.—5. Lack of Industrial Discipline.—6. How Franco Pesetas were Supported.—7. Effect of Discipline.—8. Lesson of Spanish Experience.

XXIII THE MONETARY FACTOR IN JAPAN'S FOREIGN POLICY 174

1. Overvaluation of the Yen.—2. Invergordon and Manchukuo.—3. Undervaluation of the Yen.—4. Rise in Japanese Price Level.—5. Exchange Difficulties and Expansionary Foreign Policy.—6. "Temporary" Advantages of Currency Depreciation.

XXIV FINANCIAL DIPLOMACY IN CHINA 179

1. Financial Assistance without Co-operation.—2. Disastrous American Silver Policy.—3. Financial Crisis in China.—4. Demonetisation of Silver.—5. The Leith-Ross Mission.—6. A Political Blunder.—7. Effects of Monetary Reform.—8. Chinese Resistance Encouraged.—9. German and Italian Duplicity.

XXV HOW THE SINO-JAPANESE WAR WAS FINANCED . 187

1. No Currency Depreciation.—2. Deflation in China through Moratorium.—3. No Inflation.—4. Sale of Silver to the United States.—5. Stability of the Yen.—6. No Immediate Difficulties.—7. Effect of Prolonged War.—8. Futility of Sanctions.

PART VI

THE SETBACK IN TRADE

XXVI AFTERMATH OF THE GOLD SCARE 197

1. Reflationary Trend Checked.—2. Faith in Upward Movement Broken.—3. Depression-mongering Economists and Stock Exchange Tipsters.—4. Barometer Spoils the Weather.—5. Comparison with 1929.—6. Predominant Importance of Psychological Factor.

CHAP. PAGE

XXVII THE JITTERS 203

1. Unwarranted Slump creates its own Justification.—2. Mischievous Rumours.—3. War Scares.—4. Effect on Wall Street.—5. Liquidity-Preference.—6. Repercussions in Great Britain.

XXVIII PRESIDENT ROOSEVELT'S DILEMMA . . . 208

1. De-sterilisation of Gold.—2. Wall Street Margin Requirements Relaxed.—3. Business Men Hit Back.—4. The "Rich Men's Revolt".—5. President Roosevelt's Key to the Situation.—6. Need for Sacrificing New Deal Legislation.—7. Concessions to Business and Capital.—8. Half-hearted Gestures.

XXIX SETBACK IN TRADE OUTSIDE THE UNITED STATES . 216

1. Signs of Recession in Great Britain.—2. Government's Ostrich-like Attitude.—3. Trade *v.* National Defence.—4. A Missed Opportunity.—5. The Recession in France.—6. Reactions in Other European Countries.—7. Effect Outside Europe.

PART VII

GOLD RUSH AND DOLLAR SCARE

XXX BACK TO GOLD 225

1. Anti-Climax after Gold Scare.—2. Revival of Hoarding.—3. Causes of Demand for Gold.—4. Soviet Gold Production Fears Allayed.—5. No Spectacular Increase of Output Expected.—6. Change in American Attitude.—7. Authorities satisfy Hoarding Demand.—8. Increase of Gold Deposits.

XXXI THE INVERTED GOLD SCARE 232

1. Large Increase of Turnover in London Gold Market.—2. Official Tactics.—3. Why Hoarding Movement Became Accentuated.—4. Attitude of Governments and Central Banks.—5. Inconsistent Official Policy.—6. Mistaken Tactics.

XXXII CLIMAX OF THE GOLD RUSH 238

1. Reluctance of the Authorities to Part with Gold.—2. Uncertainty about Attitude of United States.—3. "Rats leaving the Sinking Ship".—4. Mr. Morgenthau's Reassuring Statement.—5. Gold Hoarding Continues.

XXXIII DOLLAR DEVALUATION RUMOURS . . . 243

1. Reciprocal Relations between Gold and Dollar.—2. Why Dollars were weak during Gold Scare and Gold Rush.—3. Adverse Factors affecting the Dollar.—4. Devaluation Talk follows Revaluation Talk.—5. No Official Denial of Devaluation Rumours.—6. Was Dollar Scare Engineered by the Authorities?—7. Was Devaluation considered in Washington?—8. Long-range Aspects of Dollar Devaluation.

CHAP. PAGE

XXXIV THE FLIGHT FROM THE DOLLAR 250

1. Forecasts of a 50-cent Dollar.—2. Withdrawal of Foreign Funds.—3. "Hot Money" Flow Reversed.—4. United States reluctant to Lose Gold.—5. No Withdrawals through Private Arbitrage.—6. France and Other Countries benefit by Dollar Scare.—7. Mr. Morgenthau and Gold Exports.—8. Market not Altogether Reassured.—9. Moderate Pressure Continued.—10. End of Dollar Scare.

PART VIII

MINOR SCARES

XXXV THE TRAGEDY OF M. VAN ZEELAND . . . 261

1. A Victim of Ingratitude.—2. How. M. van Zeeland saved Belgium.—3. Bankers' Hostile Attitude.—4. Intrigue and Attacks.—5. The Affair of the National Bank—6. M. van Zeeland's Resignation.—7. Flight from the Belga.—8. End of the Crisis.

XXXVI THE COMEDY OF SILVER 269

1. The Case for Remonetisation of Silver.—2. Silver Group's Fateful Influence.—3. Hopeless Attempt to bolster up Silver.—4. Speculative Boom followed by Slump.—5. Fresh Wave of Uneasiness.—6. Unpromising Prospects.

XXXVII ANOTHER FRANC SCARE 275

1. Socialists exercise Moderation.—2. Concerted Attack from the Right.—3. Effect of Attack.—4. Franc Scare Subsides.—5. Labour Troubles.—6. The 40-hour Week.

PART IX

THE SITUATION IN 1938

XXXVIII GREAT BRITAIN WEIGHS HER GOLD . . . 283

1. Excessive Optimism.—2. Increase of Gold Reserve.—3. Exchange Equalisation Account's Gold.—4. Agitation in Favour of Lending Abroad.—5. Huge Trade Deficit.—6. Living in a Fool's Paradise.—7. Need for Stimulating Exports.—8. The Anglo-American Trade Negotiations.

XXXIX PRESIDENT ROOSEVELT'S DECISION TO REARM . 290

1. No further Concessions to Business.—2. The Disunited States.—3. Inconsistency of Orthodox Monetary Policy with Radical Social Policy.—4. Effect of Rearmament Announcement.—5. Political Repercussions.—6. New Dollar Scare.

XL FRANCE IN FERMENT 296

1. Uneasy Equilibrium.—2. Political Loans.—3. Subsidies to Dubious Allies.—4. New Financial and Political Crisis.—5. Political Effects of New Franc Slump.—6. Need for Social Equilibrium.—7. "France, Prends Garde!"

CHAP. PAGE

XLI HITLER DROPS THE PILOT 302

1. A Gradual Eclipse.—2. Fighting a Losing Battle.—3. Resignation Denied—then Accepted.—4. Mr. Montagu Norman's Support.—5. German efforts to Raise New Credits.—6. Guns *v.* Butter.—7. The Case against granting Credits to Germany.

PART X

CONCLUSION

XLII STABILISATION PROSPECTS 313

1. Hopes Raised by Tripartite Agreement.—2. France not Ready for Stabilisation.—3. Gold Scare and Stabilisationist Movement.—4. Effect of Trade Setback.—5. The "New Gold Standard".—6. The van Zeeland Report.

XLIII THE NEXT TWELVE MONTHS 319

1. The Unknown Political Factor.—2. Rearmament to Continue.—3. Budgets and Public Debts.—4. Foreign Exchange Prospects.—5. Gold Prospects.—6. Foreign Trade and Transfers.

XLIV FUTURE OUTLOOK 325

1. Basic Factors.—2. Devaluations and the Price Level.—3. The Burden of Indebtedness.—4. Monetary Expansion.—5. Further Devaluations Likely.—6. Rise in Prices during Next Ten Years.—7. If——.

INDEX 333

WORLD FINANCE

1937–1938

PART I
INTRODUCTORY

CHAPTER I

A YEAR OF SCARES AND JITTERS

(1) Changing Sentiments in 1937

During the period between 1931 and 1936 the world experienced a very definite trend towards monetary expansion and economic recovery. The countries which had resisted that trend for a time for considerations of monetary orthodoxy yielded to the pressure one by one. The world trend which overcame their resistance made them prosperous in spite of themselves. In the long run it proved stronger than the stubborn policy of short-sighted politicians and Central bankers. By September 1936 practically every country of importance was swimming with the tide instead of trying to swim against it.

Between 1931 and 1936 it was comparatively easy to forecast growing monetary expansion and trade recovery. The fact that in spite of this so many economists backed the wrong horse in their prophecies only shows the extent to which otherwise intelligent people allow the wish to be father to the thought. A characteristic example of this was provided by the firm belief held by a number of leading economists in January 1935 that the boom and subsequent crisis in some minor commodities such as pepper, shellac and monkey-nuts marked the beginning of the Great Slump. Apart from those who allowed themselves to be blinded to the facts by their dogmatism, everybody realised that the upward movement in trade was bound to continue for some time. Money was as cheap as ever. Most Governments pursued a policy of deliberate expansion. Budgets were unbalanced owing to public works expenditure and, subsequently, rearmament. Compared with the pre-1929 level, commodity prices were still too low. On the basis of these facts, it was not difficult to prophesy that the era of prosperity would continue. Economic prophets had a comparatively easy time until towards the end of 1936.

During the spring of 1937, however, doubts began to arise in the minds of expert and layman alike. The majority of

prophets were no longer quite so certain that it was safe to forecast a further rise in commodity prices and a further expansion of trade. A large and increasing number of investors, speculators, producers, merchants and bankers began to feel that the cat might jump either way. During the first quarter of the year, many people were much less happy than they had been in 1936. Although the commodity boom continued, it became too rapid and too speculative for the liking of most people. Stock Exchanges became hesitant and rises were followed by minor relapses. In particular, the markets for Government loans in the leading countries assumed a definitely downward trend, giving rise to an impression that the cheap money period was drawing near conclusion. Nevertheless, the predominant feeling was that, notwithstanding the gloomy prophecies from quarters which have been invariably gloomy and invariably wrong during the past five years, the upward trend in trade would continue. The majority of the public retained a firm belief in continuous reflation.

(2) A Series of Shocks

From April 1937 onward, however, the optimistic world received a series of more or less violent shocks. The faith of the public in non-stop reflation became gradually undermined by the scares that followed one another in close succession in the course of a few months. We experienced a gold scare, a National Defence Contribution scare, several "peace scares" and war scares, several franc scares, a dollar scare, an "inverted gold scare," a belga scare and a silver scare. The first and by far the most important of them all was the gold scare. It began early in April and attained its climax two months later. It petered out almost exactly three months after it began, and left the markets with nerves severely shaken.

Simultaneously with the gold scare, several other scares were running their course. In Great Britain, in particular, the effects of the gold scare were accentuated by those of the National Defence Contribution scare, which began with Mr. Chamberlain's budget statement on April 20, and ended with the Government's decision not to press its original scheme of taxation in face of almost unanimous opposition. At the same time the markets experienced one or two "peace scares" —an expression coined by City cynics to indicate the fear that some international agreement might bring the rearmament race to an end. Nor were war scares entirely lacking, even though the worst of them did not come until the autumn.

It is characteristic of the inconsistency of market minds that the effect of " peace scares " and war scares was exactly the same.

When the gold scare was drawing to its end, the first of a series of franc scares replaced it as the provider of excitement and uneasiness. While the consequences of a possible devaluation of the franc were viewed with optimism during 1935 and 1936, the public within and outside France began to take a gloomier view of them during 1937. The inadequate result of the franc devaluation of September 1936 gave rise to a feeling that even a further depreciation would fail to solve the French problem, which had come to be regarded as impossible to solve. Every fresh fall in the franc between June and October was regarded as merely another step towards the inevitable collapse with all its internal and international political consequences. It is therefore no wonder that the franc crisis contributed to the general uneasiness.

Towards the end of the summer of 1937, a Wall Street scare began to develop. It went on increasing until December, and was accompanied by a spreading gloom about trade prospects in general in the United States and elsewhere. By that time the world was in the throes of " the jitters ", and was ready to expect the worst from every direction. Rumours of an impending devaluation of the dollar found fertile soil and led to a dollar scare and an " inverted " gold scare—that is, to a reversal of the flight from gold that had taken place a few months earlier.

(3) Resistance to Reflation

Although the year 1937 may best be described as a year of scares and jitters, it had also other outstanding characteristic features. In most countries the resistance to the trend of reflation, which was to provide the solution to excessive indebtedness and hopelessly unbalanced budgets, continued unabated. In France the Government of M. Blum, having devalued too late and to an inadequate degree, was as stubborn in resisting a further adjustment of the franc as it had been during the first four months of its existence in resisting the inevitable devaluation. In Great Britain the money required for rearmament was borrowed long before it was spent, with inevitable deflationary results. In Italy the lira was considered as sacrosanct at the level to which it had been devalued in October 1936 as it had been at its previous level, in spite of the growing adverse pressure which was slowly but

thoroughly depleting the gold and foreign exchange reserve of the country. Even President Roosevelt, the originator and patron saint of reflation, became an apostate to his own doctrine. It was to a very large degree his anti-reflationary measures during the second half of 1936 and his anti-reflationary statement in March 1937 that opened the door to the doubts, scares and jitters. In the late summer and autumn of 1937 he repented and reverted to his deserted doctrine, but it was already too late to avoid the adverse consequences of his temporary departure from it.

(4) The Rich Men's Revolt

There was yet another characteristic feature of the year: 1937 was the year of the Rich Men's Revolt in the democratic countries against Government, Parliament and the electorate. Before 1937, capitalists, industrialists and bankers had meekly submitted to the policy practised by their Government with the approval of Parliament and the majority of constituents. The popular outcry was to "soak the rich", and the rich allowed themselves to be soaked. In Great Britain, where a Government controlled by the Conservative Party had been in office since 1931, this soaking was very moderate indeed. It consisted of a cheap money policy, leading to a reduction of interest rates on Government loans and other fixed-interest-bearing securities. This policy had the full support of those who, besides being rich men, were also concerned with production and trade, but was strongly disapproved of in rentier quarters. Apart from this, the extent to which rich people as such were especially soaked through taxation or other measures—though it gave rise to much protest against "Socialism practised by Conservatives"—was negligible. Not so in the United States and France. The policy of President Roosevelt's Radical administration was directed against Big Business, and soaking the rich was its favourite slogan. Even though bankers and business men who had been cowed by the various anti-rich measures adopted in 1933, gradually began to raise their heads, they did not at first display any particular resistance to President Roosevelt's anti-rich policy, beyond the opposition put up by the Washington Supreme Court. In France, after the Socialist victory of 1936, the Blum Government adopted a strongly anti-capitalist policy, and capitalists, stunned by the series of blows which they had received, were unable for the moment to display active resistance.

It was in France that the Rich Men first began to hit back. Their retaliation consisted of refusing to repatriate their capital, and of sending more and more funds abroad, even after the devaluation of the franc. Their attitude was described as a sit-down strike of capital in reply to the stay-in strikes of labour. MM. Blum and Vincent Auriol, having done their best to break their resistance, ended by yielding to them in March 1937, when M. Auriol relinquished to a neutral committee of experts an important part of his control over monetary policy. In June the Rich Men's Revolt in France scored a major victory by bringing about the defeat of the Blum Government and its replacement by a more moderate Government. Even this did not satisfy the Rich Men, whose resistance continued, in the absence of satisfactory evidence that the new Government would be able to resist anti-capitalist influence. It was only when such evidence was forthcoming in October 1937 that the Rich Men relented for a time and the Government was given a chance.

In Great Britain the Rich Men's Revolt was provoked by Mr. Chamberlain's National Defence Contribution. Until his budget speech of April 1937, the Government had been regarded as essentially a Rich Men's Government, and Mr. Chamberlain himself had been regarded in Radical quarters as the Supreme Protector of rearmament profiteers. This impression was dispelled at one stroke when Mr. Chamberlain declared his decision to tax the excess profits due to rearmament prosperity. There was an outcry among representatives of capital and enterprise, which, in some instances, bordered on hysterics. The expressions used could not have been more violent if Mr. Chamberlain had confiscated private property without compensation. All the spokesmen of business interests did their utmost to exaggerate to the extreme the probable disastrous consequences of the N.D.C. The result was an excessive slump on the Stock Exchange. This, together with the almost unanimous opposition of the City, industrial interests and the Conservative party, backed up by the short-sighted party tacticians of the Labour party, induced Mr. Chamberlain to yield to the revolt by abandoning his original N.D.C. scheme.

In the United States, the strong disapproval which President Roosevelt's policy encountered in Wall Street and among rich men in general became accentuated when the Wages and Hours Bill was introduced. This, like the 40-hour week and paid holidays legislation in France, was as a red rag to the capitalist bulls. American capitalists were unable to force

the Government's hand by the means employed by their French colleagues. An outflow of capital would have been welcomed by President Roosevelt, since it would have reduced the amount of his pet aversion, "hot money". Thus the Rich Men's Revolt in the United States assumed the form of abstaining from spending on the part of public utilities and industrial undertakings. Rightly or wrongly, manufacturers got it into their heads that under the new legislation they would be unable to make any profit at all, and acted accordingly. The result was a small business recession which led to a Wall Street slump; this in turn accentuated the business recession. As a result, President Roosevelt had to follow the example of his British and French colleagues up to a point and yield to a large extent to the Rich Men's Revolt.

(5) The Psychological Factor

Another remarkable feature of the year was the evidence of the supreme importance of the psychological factor. After the experience of 1937, there can be no doubt that in the short run, at any rate, psychological factors may easily defeat the material factors. In 1937, as in previous years, most of the known material factors of importance were in favour of a continued upward trend. Notwithstanding this, the psychological factor brought about a series of scares, and these scares brought about the jitters, which led to the Wall Street slump and to a trade recession well beyond the borders of the United States, in defiance of the material factors. This setback was engineered to a large extent by economists who, by forecasting a slump, stimulated the prevailing pessimism and distrust. In previous years, when the undertone was optimistic, their gloomy prophecies were ignored, but in 1937 the atmosphere was favourable to such pronouncements, which received an extensive hearing and accentuated the wave of pessimism.

(6) Rehabilitation of Gold

Finally, a characteristic feature of the year was the rehabilitation of gold. During the gold scare, most experts and pseudo-experts outbid each other in their attempts to discredit the metal. It appeared for a time as though gold had descended from the pedestal where it had stood, in the eyes of mankind, for thousands of years. The inverted gold scare that took place in the autumn, however, showed how utterly wrong the detractors of gold had been, and how deeply rooted was the world's veneration for gold. It became evident that whenever

political, economic and financial conditions grew thoroughly uncertain, the public would seek safety in gold.

Amidst all the scares and jitters, it was not easy to keep aloof from the prevailing trend of sentiments. Nevertheless, those capable of discriminating between basic facts and surface developments have had no reason to change the opinion which they formed in earlier years on the basis of the same fundamental facts. These facts, which in the long run are bound to determine the trend of developments, are: the expansion of the gold basis of the credit structure; demand for commodities and expenditure of public funds in connection with rearmament; budgetary deficits and an excessive public debt, which can only be remedied through a further depreciation of the currencies; the Governments' desire to acquire and retain popularity by keeping employment at a high level. All these factors indicate an upward trend. They may be temporarily overlooked or underrated during a wave of pessimism, but they remain in existence nevertheless, and in the long run they are bound to make themselves felt.

CHAPTER II

SCOPE OF THE BOOK

(1) Introductory

Before surveying the financial history of the past twelve months, it is necessary for us to recapitulate the events and developments of the period during which the trends and factors responsible for the present situation came into being. It is not easy to decide which period should be covered by this introductory survey. Many authors, writing even purely technical books on the bill of exchange or similar subjects, have considered it their duty to begin with Adam and Eve, and to explain the present position on the basis of the behaviour of cavemen. It is hardly possible for any Latin author to write on any subject without beginning with the French Revolution which is regarded as the starting-point of everything that exists to-day. At the other extreme there are the majority of authors and editors of year-books which deal with the year under review as if it were entirely independent of any previous period. My choice of the period beginning in 1914 as the era which should be covered by this recapitulation is based on the fact that to a very large degree the present situation is the result of economic and financial developments during the war of 1914–18. Admittedly, many tendencies which exist to-day, such as the excessive volume of international floating indebtedness, already existed to a moderate degree before the war. It is, however, only since 1914 that this and other important factors have developed on a really large scale and at a really rapid pace. Anyone who tried to understand the present situation and the developments of the recent past without a general knowledge of developments since 1914 would find many blank spaces which he would be unable to fill.

(2) The Gold Scare

After a brief survey, in Chapter III, of the financial history of the period from 1914 to the early part of 1937, the next task is to deal with the major tendencies and events of the year, as

indicated briefly in Chapter I. First, among the subjects to be covered, both in chronological order and in importance, is the gold scare. Admittedly, it does not occupy as central a position in this book as did the death struggle of the Gold Bloc in *World Finance, 1935–1937*, but it was the outstanding phenomenon of the year, and deserves detailed discussion. Accordingly, Part II of the book is devoted to this subject. In the first place, the way in which the gold position developed almost imperceptibly from one of acute scarcity to one of abundance is examined. Such a description is necessary in order to show that there was no sudden change in April 1937, but a gradual change spread over a series of years. On the material factors alone a gold scare would have been equally justified or unjustified at any time from 1935 onwards, since the difference between the situation of April 1937 and that of two years earlier was merely one of degree.

Following upon the account of the development of the gold situation between 1931 and 1937 in Chapter IV, Chapter V describes the actual origins of the gold scare itself. It will be seen that the flight from gold and gold-mining shares, which at times assumed panic-like dimensions, was due to the coincidence of a number of surface factors, and to the gross exaggeration of their significance, not only by speculators, investors, arbitrageurs and others who necessarily live in the present, but also by those whose task in life is to take a broader view and detach themselves from surface influences. The attitude of these " gold scare-mongers " is criticised in the next chapter, which is an indictment of those economists and super-bankers who allowed themselves to be stampeded into panic and who, by their attitude, accentuated the panic of the public.

Chapter VII gives a critical examination of the official tactics and policy pursued in face of the gold scare. While the British and American authorities unquestionably committed a number of glaring blunders, their refusal to be frightened into the suicidal decision to lower the price of gold deserves recognition. Chapter VIII describes how the gold scare reached its climax and how it subsided. It lays stress upon the sudden change of market sentiment. Just as speculators, investors and arbitrageurs preceded the man of theory in discovering the gold scare, so they were the first to perceive that the gold scare was over, while economists and the " intellectual upper ten " in the banking world were still under the impression that the gold scare had come to stay.

(3) The Tragi-Comedy of the Franc

Part III deals with the depreciation of the franc by degrees between March and October 1937. Chapter IX criticises the mismanagement of the devaluation of September 1936, and describes the consequences of the series of mistakes committed. In Chapter X the attempt at a correction of these mistakes through the compromise reached in March 1937 is dealt with. As a result of this compromise, there was a temporary truce between the Government and its capitalist opponents. Chapter XI described the revival of hostilities leading to the downfall of the Blum Government.

Chapter XII gives a description of the efforts made by the new Chautemps-Bonnet Government to find a solution through a gradual depreciation of the franc and a supreme effort to reduce the budgetary deficit. The franc was allowed to depreciate, and the climax of this movement is dealt with in the next chapter. In Chapter XIV the unexpected recovery of the franc during October 1937 and its subsequent temporary stability are discussed.

(4) Armament Finance

Part IV deals with the subject of armament finance. In Chapter XV the general monetary trend and its relation to rearmament form the subject of discussion.

Chapters XVI and XVII deal with developments in British rearmament finance, with special regard to Mr. Chamberlain's National Defence Contribution scheme. The major problems of rearmament finance, which exist to a greater or less degree in every country engaged in rearmament, are discussed with regard to the special British conditions. The selfish and short-sighted attitude of those who opposed Mr. Chamberlain's N.D.C. is subject to critical examination.

The following chapter discusses French rearmament finance, particularly from the point of view of the value of the franc. It points out that the resistance to the depreciation of the franc continued to constitute a handicap to efficient progress in rearmament even after the devaluation in September 1936, but that eventually considerations of national defence prevailed. Chapter XIX deals with German rearmament finance, which caused the downfall of the economic dictator, Dr. Schacht. His resistance to expenditure failed to check the trend, and in opposing rearmament expenditure he lost the support of the Reichswehr, which until then had regarded him

as its economic representative in the Cabinet. Chapter XX gives an account of the difficulties of Italian rearmament finance. It will be seen that while its difficulties are apt to be exaggerated as far as internal finance is concerned, they were very substantial indeed regarding the financing of rearmament imports.

(5) War Finance

Part V deals with armament finance in the countries which are actually at war—Spain, Japan and China. The origins of the Spanish Civil War are clearly traceable to the misguided policy pursued during the dictatorship of Primo de Rivera. Chapter XXI indicates the way in which a policy of prestige in the matter of currency landed Spain in the economic difficulties which were responsible for the overthrow of the dictatorship and the monarchy, and prepared the ground for the tragic developments of subsequent years. The following chapter examines war finance in both Government-controlled and Insurgent-controlled Spain.

In Chapter XXIII the Japanese situation leading to the armed conflict in the Far East is explained. Here again, the connection between the monetary situation and the developments in foreign policy is unmistakably evident. Chapter XXIV gives an account of financial developments in China prior to the outbreak of the war. The experience should serve as a lesson indicating the futility of the finesses of financial diplomacy in face of force of arms. The following chapter, which deals with actual war finance in both Japan and China since the beginning of the hostilities, shows that nowadays there is always enough money when it is required for war.

(6) The Setback in Trade

Part VI examines the setback experienced in the United States and, to a less extent, in other countries, in the late summer and autumn of 1937. Chapter XXVI is an indictment of economists, Stock Exchange tipsters and others whose pessimism was largely responsible for the Wall Street slump and the trade recession. In Chapter XXVII the effect of the various scares on market nerves is described. In the following chapter the consequences of President Roosevelt's advanced New Deal legislation are compared with the French Front Populaire experiment. The part played by the Rich Men's Revolt in the United States in bringing about trade recession

is examined. Chapter XXIX describes the effects of the setback outside the United States.

(7) Gold Rush and Dollar Scare

Part VII deals with what may well be described as the "inverted gold scare", and with the flight from the dollar which developed almost simultaneously with it. We shall see in Chapter XXX how the cessation of the gold scare was followed in due course by a gradual resumption of hoarding. Chapter XXXI deals with the accentuation of the movement into something like a flight to gold. The next chapter deals with the climax of the movement, and with the circumstances which led to its subsequent decline.

Chapter XXXII deals with the dollar scare which developed almost simultaneously with the flight to gold, and in close connection with it. It explains how and why dollar devaluation rumours arose and found ready believers. In Chapter XXXIV the flight from the dollar is described, and the reason for its temporary cessation explained.

(8) Minor Scares

Part VIII deals with the minor scares which were experienced shortly before the end of 1937. In the first place the belga was endangered as a result of the resignation of M. van Zeeland. Chapter XXXV explains how the crisis arose and how it subsided, thanks to the shifting of the storm centre to the United States. If M. van Zeeland's resignation had all the elements of a tragedy, the minor scare which arose in the silver market, described in the next chapter, had many of the characteristics of comedy. The solution of the silver problem, created through President Roosevelt's ill-advised silver policy, is examined in order to trace the origins of the minor silver scare. Chapter XXXVII deals with the minor franc scare, with which the year so rich in scares closed.

(9) The Situation in 1938

Part IX carries the reader over to 1938. Chapter XXXVIII examines the British position, with particular regard to the increase of the gold reserve. It gives a warning against undue optimism, on the ground that the increase is more or less offset by a corresponding increase of London's short term liabilities. Chapter XXXIX describes the outlook in the American trade recession which, by the turn of the year, threatened to develop into a major trade depression. It indicates the hope that

President Roosevelt's decision that the United States should rearm on a large scale may break the deadlock and bring about a resumption of the upward movement in the United States and elsewhere.

Chapter XL deals with the disturbing developments in France during the early part of 1938, leading to the failure of the first Chautemps Government. In the following chapter, Germany's position and prospects after Dr. Schacht's departure from the Ministry of National Economy are described.

(10) Conclusion

The final part of the book deals in the first instance with the prospects of monetary stabilisation. Chapter XLII points out that stabilisation in the old sense of the term is not likely to come for a long time, and conceivably never, since according to a strong current of opinion the present system of informal and elastic stability, described as the new gold standard, has come to stay. In this connection, the chances of the van Zeeland Report are examined. Chapter XLIII attempts to forecast the probable developments during the next twelve months, while the last chapter of the book attempts to indicate the probable trend of developments in the long run.

CHAPTER III

WORLD FINANCE, 1914–37

(1) Quarter of Century of Financial Revolution

One is apt to exaggerate the significance of events occurring during one's own time compared with those which occurred during past periods. This is only natural, since our own economic and financial ailments are bound to hurt us much more than the study of similar ailments in our ancestors can possibly hurt even the most sensitive of us. But even allowing for this consideration, there can be no doubt that the developments since 1914 in the sphere of world finance have been more spectacular than those of any previous period in history, or, at any rate, in modern history. The world has witnessed a series of violent ups and downs in the sphere of finance; the extent of fluctuations, in various senses of the term, has been much wider than ever before in such a brief space of time; various predominant factors have developed with dramatic rapidity and produced sweeping effects, only to disappear with equal suddenness in order to be replaced by new sets of factors.

There is, indeed, every reason to describe the last quarter of a century as a period of financial revolution. There can be little doubt that unless in future periods the pace of evolution in the sphere of finance becomes even more rapid and accentuated, the historian of future generations will regard the developments since 1914 as having been of a revolutionary character. It is much more justifiable to refer to this epoch as one of financial revolution than it is to describe the very slow process of industrialisation during the nineteenth century as industrial revolution. That process took about a century, and its effects were no more fundamental than those of the financial revolution of our days.

An account of the facts of this period will undoubtedly make interesting reading for the future student of financial history. A description of the development of world conceptions in matters of finance since 1914 is, however, hardly less interesting. The extent to which changes in situations

affect public opinion and even expert opinion, how situations lead to the development of theories and how those theories are discarded and replaced when the situation changes, makes a very instructive study.

(2) Repressed Inflation during the War

The first phase in world finance after the outbreak of the war in 1914 may be described as one of repressed inflation. It was repressed, not in the sense that there was self-restraint on the part of the inflationary monetary authorities—there could be no such thing in the life-and-death struggle—but in the sense that the outward symptoms were to a large degree concealed from the public. The printing press was busy in every belligerent country. There was inflation of incomes and profit inflation. These factors, however, were not allowed to produce their natural effect on prices and exchanges. Price control and exchange control were adopted, and for years the barometer was successfully kept out of action. This did not mean that there was no bad weather, but only that the public, depending upon the barometer for information, did not realise it. The factors making for inflation were at work to an increasing degree throughout the four years of the war.

The popular conception held during that period, not only by the general public but even in official circles and among a large number of experts, was that all the abnormal developments which were due to the war would disappear soon after hostilities ceased. While experts realised that there was bound to be a " transition period ", during which war economy would re-adapt itself to peace conditions, few people had any doubt that after a while the world would return to a financial state very similar to that of 1913. The public was not inflation-conscious. It could not help becoming conscious of the rise in prices, which took place notwithstanding various efforts at price control and exchange control, but it regarded this trend as being due to shortage of commodities through blockades and other war conditions.

(3) Uncontrolled Inflation after the War

The period of repressed inflation came to an end in the defeated countries immediately after the termination of hostilities. The weak Governments set up through the revolution in Central Europe were incapable of continuing price control and exchange control, and from November 1918 onwards inflation showed itself openly in Germany, Austria and Hun-

gary. In the allied countries, exchange control was maintained until the middle of 1919, but thereafter the true effects of inflation began to manifest themselves. In most countries, whether victor or vanquished, inflationary expenditure did not cease with the conclusion of the Armistice, or even with the conclusion of the Peace Treaties. Budgetary deficits continued to be financed with the aid of the printing press and a large part of the world entered into the era of uncontrolled inflation.

By that time the true meaning and consequences of inflation were beginning to be realised. World opinion was, however, still divided about the ultimate consequences. The public in the countries which were undergoing extreme inflation began to exaggerate its extent and discount its future effects, thereby accentuating and accelerating its destructive course. The conception developed that nothing could ever stop the slump in the value of the national currencies, and *sauve qui peut* was the slogan adopted.

In countries where inflation did not reach an advanced stage, the public and the authorities were reluctant to admit that its effects might be lasting. The view was that all this was simply the belated effect of the war, and that sooner or later it would be possible to put the clock back to 1913. Translated into terms of practical monetary policy, this meant that the object to be pursued was the restoration of currencies to their pre-war level irrespective of the fundamental changes that had taken place as a result of reckless war and post-war expenditure. The fact that the public debt was many times its pre-war figure and that the gold basis now had to support a larger superstructure of fictitious wealth does not seem to have been realised. Those countries which were technically in a position to return to their pre-war parities considered it their sacred duty to do so. Even countries which were obviously not in a position to follow their example were reluctant to admit this fact.

(4) Chaos and Climax

Uncontrolled inflation as a world-wide movement came to its climax in 1920. Thereupon a period of deflation set in, at least in a number of countries, while the rest of the world continued to inflate. In order to return to pre-war parity, Great Britain and a number of other countries adopted deliberate deflationary measures, although this meant heavy sacrifices in the form of loss of trade and heavy taxation. Even the

United States resorted to deflation, thereby setting the pace for other countries which wanted their currencies to be able to look the dollar in the face. Instead of cutting their losses and stabilising at a level at which the increased volume of indebtedness would have become bearable, and at which the existing gold stock would have provided an adequate safety margin, they were determined to put the clock back to 1913 irrespective of cost and regardless of consequences. At the same time other countries were unable or unwilling to balance their budgets, and continued to inflate, thereby widening the gap between the intrinsic value of their currencies and that of the currencies of the deflationary countries. All the defeated countries of Central Europe, and also Poland, Soviet Russia and, to a less extent, the victorious countries of Western Europe, with the exception of Great Britain, belonged to the category of inflating countries. Deflation and inflation were thus running concurrently in various countries of Europe. Accordingly, world opinion was characterised during that period by sharp contrast between excessive optimism in some countries and excessive pessimism in others.

(5) Stabilisation through Devaluation and Deflation

From the world-wide chaos emerged the world-wide movement towards stabilisation. It is worth noting that in some instances, at any rate, the inflationary countries attained this goal before the deflationary countries. Czechoslovakia, Germany, Austria and Hungary stabilised before Great Britain and the neutral countries, simply because, having realised the utter futility of any attempt to restore their currencies to pre-war parity, they decided to stabilise at or near bottom level. Currencies like the pound, the Swiss franc, the Dutch guilder and the Swedish krona were not very far removed from their pre-war parity, so that technically it was possible for them to be restored. It took a long time, however, to attain that end. Most difficult of all was the task of the countries which occupied an intermediary stage between these two groups. France, Italy, Belgium and other Western European countries delayed the stabilisation of their currencies, partly out of sheer necessity owing to their unbalanced budgets and partly because of the lingering hope that they might, after all, restore the pre-war parity.

Thus the stabilisation of the currencies was spread over a prolonged period. It began with the Czechoslovak stabilisation in 1922 and ended with the Spanish stabilisation in 1931.

Each country decided upon the stabilisation of its currency independently of others, and the choice of the rates was purely fortuitous. It was taken for granted that once the exchanges were stabilised the whole financial and economic system would adjust itself to the new parities. This optimism was only exceeded by the optimism implied in the conception that a currency had only to be pronounced stable in order to remain stable. None of the fundamental problems making for disequilibrium and instability was solved, and yet it was generally expected that once the currencies were linked to gold by legislation, they would maintain their stability.

(6) Surface Stability *v.* Fundamental Disequilibrium

In the course of the years that followed the stabilisation of the principal currencies, the underlying difficulties gradually became obvious. Countries such as Great Britain and Italy, which had overvalued their currencies, had to face a trade depression, and even at that price it was not always easy to maintain stability. The world as a whole was beginning to realise the inadequacy of the gold stocks in face of the increased requirements. The circumstances in which stabilisations were carried out precluded the possibility of bringing about a better distribution of gold ; in fact, the maldistribution tended to become more and more accentuated. The reluctance of countries with an excessive gold reserve to allow the surplus to produce its effect upon their credit structure and prices, and the reluctance of the countries with inadequate gold reserves to deflate sufficiently, led to the development of international disequilibrium. The implicit faith that the period of stability would last resulted in excessive international lending, bringing about the growth of international floating indebtedness. In face of these trends, the monetary authorities sought to defend stability by means of various palliatives, especially through co-operation between Central Banks in moderating the demand for gold. Practical necessity gave rise to new theories about the wisdom and moral superiority of methods of economy in the use of gold.

In the light of subsequent events, it may now appear amazing that statesmen and economists expected to be able to hold off the coming earthquake by means of such pills. It seems to be the destiny of mankind that each generation should learn only at its own expense, and it would perhaps be too much to expect its leaders and advisers to realise the utter futility of bolstering up the situation in face of the funda-

mental disequilibrium that required correction. The gold basis was much too small for the credit structure, from the point of view of both international requirements and the internal requirements of all but two or three countries with a gold surplus. Since it was impossible to correct the situation through either an increase of the gold stock or a reduction of requirements, the only way in which an adjustment could possibly be hoped for was through a depreciation of the monetary unit. Few people realised this, and even they did not dare to put the truth into words. Lord Bradbury, in his minority report attached to the Macmillan report, gave a correct diagnosis of the disease, but had not the courage to state the only logical conclusion which could possibly be inferred from his premises, namely that the remedy lay in the depreciation of sterling.

(7) Crisis and Deflation

In 1929 came the inevitable slump, followed by the inevitable series of financial crises from 1931 onwards. At first the disequilibrium sought to correct itself through a downward adjustment of commodity prices. While this process tended to reduce requirements for gold, at the same time it increased the disequilibrium due to the excessive burden of indebtedness, since that burden increased in terms of commodities. It was impossible for a slump in commodities to provide the solution required. The slump was followed by a series of defaults, leading to the cancellation of much fictitious wealth. The strain thus caused proved, however, too strong for the vulnerable currencies to resist. One currency after another had to be allowed to depreciate. Since the limitations of human wisdom precluded the possibility of a deliberate and orderly adjustment of currencies, it was inevitable that the downward adjustment should take place in the midst of violent crises. Even then, most Governments displayed a stubborn resistance to the natural process of readjustment which took place.

Once more the world became divided into two groups of countries—those which had yielded to the reflationary forces and were on their way towards recovery, and those which had resisted their own salvation and defended their currencies with the aid of desperate deflationary measures. Quite a cult of deflation developed in those countries. Reductions in expenditure, public and private, were made to appear the highest form of civic virtue. Politicians, experts and the Press spared no arguments to stimulate optimism regarding

the prospects of a successful defence of the currencies through deflation. At the same time, in the reflationary countries, a cult of spending one's way to prosperity developed. Cheap money, public works, currency depreciation, all tended to encourage spending, or removed obstacles which tended to discourage spending. Once more, as during the period of post-war currency chaos, the discrepancy between conditions in deflationary and inflationary countries became increasingly marked. This time, however, it was the deflationary countries which were threatened with chaotic conditions. The moderate degree of expansion in the reflationary countries was not sufficient to lead to the disastrous consequences which generally follow reckless inflation. On the other hand, the deflationary efforts in the other group of countries reduced their prosperity to bare subsistence level, and threatened their political stability.

(8) All-round Devaluation and Reflation

It was inevitable that sooner or later the deflationary countries should fall in line with the reflationary countries. One after the other had to abandon the futile resistance to the depreciation of its currency, and by September 1936 France, the last stronghold of deflation, had also capitulated to the superior forces of reflation. By the end of 1936 the reflationary tendency reigned supreme, virtually all over the world. This tendency received powerful reinforcement from the development of an international rearmament race. Although the balancing of the budgets was still declared to be the supreme goal of financial statesmanship, most experts admitted that capital expenditure on rearmament could not be expected to be met out of current revenue. The Governments were no longer spending in order to reflate; they were reflating in order to spend. Reflation and rearmament led to a higher degree of recovery in almost every country. The conception gained ground that amidst the feverish rearmament expenditure, prices and trade could only move in an upward direction. As a result of this, the upward trend became accelerated and, by the beginning of 1937, it began to assume the characteristics of a speculative boom.

The vicious circle which began in 1914 with war inflation, followed by post-war deflation and stabilisation, slump and voluntary or forced reflation, has returned to its starting point. Once more, Europe and a large part of the rest of the world is inflating for the requirements of rearmament.

PART II
THE GOLD SCARE

CHAPTER IV

FROM SCARCITY TO ABUNDANCE

(1) The Unexpected Gold Scare

In the autumn of 1936 it looked as though, through the devaluation of the Gold Bloc currencies, the international monetary problem had at last found a temporary solution. Admittedly, it was fairly obvious to many of us that sooner or later further devaluations or depreciations would become necessary. This problem did not, however, appear to be urgent except in countries such as France, where there was pressure calling for an immediate downward adjustment of the currency. Generally speaking, there seemed to be no reason why the international monetary system should not enjoy comparative stability for the next year or two.

In the circumstances the gold scare of 1937 came as a bolt from the blue. It was all the more unexpected since it was the manifestation of a tendency temporarily opposed to the fundamental trend, which was towards a further rise in the price of gold in terms of various currencies. Even though most experts did not realise at the beginning of 1937 that in the long run a further depreciation of currencies in terms of gold would become necessary, few of them thought of suggesting or prophesying an appreciation. Even at the end of March, hardly any economists advocated an upward revaluation of the currencies or a cut in the price of gold, although a few weeks later the name of those agitating for such a course was legion. Before April 1937, hardly anyone suggested that there was, or was likely to be, too much gold. During the second quarter of the year, however, almost every economist of standing considered it his duty to join in the chorus announcing to the world that there was a superabundance of gold calling for drastic remedy.

Beyond doubt the years between 1931 and 1937 witnessed a substantial increase in the volume and value of the total gold stocks. While in 1931 there was unquestionably a scarcity of gold, in 1937 gold was undoubtedly abundant, even though not necessarily superabundant.

(2) Was there a Gold Shortage before 1931?

In face of this changed situation, most people were apt to forget the inconvenience caused by the scarcity of gold about ten years ago. For this reason the figures showing an increase in the world's monetary stock of gold since 1931 seemed unduly to impress the public. It was not adequately realised that, as before 1931 the gold stock had been highly deficient, a very considerable increase between 1931 and 1937 was necessary and justifiable. It is therefore not superfluous to recall the gold situation during the period of stability between 1925 and 1931.

Orthodox economists favouring deflation consider it their duty to deny the fact of gold scarcity during that period. Some of them, in a conciliatory mood, are prepared to admit that there was maldistribution, but deny that the world's total monetary stock of gold was short of requirements. What are the facts? Between 1913 and 1925 the world's monetary stock of gold increased by about one-third. Between 1913 and the end of 1930 the increase was about 54 per cent. Roughly it corresponded to the average increase in wholesale and retail prices, wages and the cost of living. It did not nearly correspond, however, to the much more pronounced increase in the volume of credit, both internal and international, or in the volume of indebtedness. Thus the gold foundation upon which the enlarged superstructure rested was, relatively speaking, much smaller than it had been before the war.

The credit expansion in various countries was far in excess of the expansion in the amount of the gold reserve. What is even more important, the increase in the gold stock did not keep pace with the sharp increase in the world's gold requirements due to the larger volume of international floating indebtedness. The amount of gold that had to be kept for the purpose of international transfers of funds not connected with foreign trade was many times larger than before the war.

(3) Maldistribution of Gold

Even if there had been a satisfactory distribution of the gold stock, there would have been a scarcity. In reality the effect of the scarcity of the gold stock was considerably aggravated by the existence of a high degree of maldistribution. The United States and France possessed far too large a proportion of the world's gold stock, and most countries had

to do with inadequate stocks in consequence. The American and French gold stocks did not serve as a basis for credit expansion to a sufficient extent. In many other countries, on the other hand, there was not enough gold to provide for an adequate volume of credit without taking undue risks. It became necessary to use the same gold as a basis for credit in two countries through the working of the gold exchange standard.

(4) Palliatives

The existence of a scarcity of gold before 1931 gave rise to much anxiety, and was considered the major financial problem of the period. Central Bankers, Treasury officials, economists and monetary experts studied it with growing concern. The League of Nations appointed a Gold Delegation, and the Bank for International Settlements was formed largely with the idea of overcoming the shortage of gold. Wherever economists or bankers met in international gatherings, the problem was discussed, and the literature on the subject grew to formidable proportions. In face of the gold scarcity, Central Banks agreed to bury their differences and co-operate in order to avoid a scramble for gold. It was agreed that there should be no sudden gold withdrawals on official account from countries which could ill afford to lose gold. A number of Central Banks were persuaded to keep a large part of their metallic reserves in the form of foreign exchange instead of gold, and in most countries gold coins were almost entirely withdrawn from circulation in order to swell the monetary reserves. Various devices were elaborated as to how to economise in the use of gold.

All these efforts were of no avail to remedy the evil of gold shortage. This shortage was largely responsible for the slump which began in 1929, and was almost entirely responsible for the international financial crisis that followed it from 1931 onward. Had the world possessed an adequate gold stock, the extent of the slump in commodity prices that followed the Wall Street slump would have been much more moderate. It would have been easier to meet the run on the various currencies that developed in 1931. An increase in world production would gradually have offset the increase of indebtedness and fictitious wealth in general which had resulted from the war and its aftermath.

(5) How Gold Scarcity was Relieved

The depreciation or devaluation of a number of currencies between 1931 and 1936 brought relief to the gold position in two ways. It resulted in the writing up of the gold stocks of a number of countries and it stimulated current output. It also led to a somewhat better distribution of gold, at any rate between 1931 and 1934, as a result of the decline of the American gold stock and the increase of the gold stock of several European countries.

The depreciation of currencies brought relief to the gold situation in many instances by leading to the writing up of the official gold reserves in terms of the national monetary unit. In consequence, large amounts of gold, which had hitherto been indispensable as the minimum gold backing to the currencies concerned, were released and became available for international purposes. This was true only concerning countries which had actually devalued their currencies. In countries such as Great Britain, which had fixed no new legal parity, and where the official gold reserve was still reckoned on the basis of the old parity, relief was obtained only through the depreciation of the currency, which led to the increase of the purchasing power of gold in terms of commodities. Since the gold equivalent of the same volume of international trade declined, a smaller amount of gold became sufficient to finance trade balances, assuming, of course, that the absolute or relative size had not materially changed.

Depreciation of the currencies brought relief to the gold situation because commodity prices did not rise in proportion to the increase in the nominal value of the gold stocks. If commodity prices, wages, cost of living, etc., had adjusted themselves to the changed gold value of the currency, then the writing-up of gold reserves would not have been any relief, since the nominal amount of total gold requirements would have increased in the same proportion. Nor would it have been possible to obtain relief through an increase in the commodity value of gold. It was the time lag between the reduction of the gold value of currencies and the adjustment of prices to that new gold value which was largely responsible for relieving the gold shortage.

(6) Writing-up of Gold Stock

This relief came gradually from the time of the suspension of the gold standard in Great Britain. The depreciation

of sterling and the Sterling Bloc currencies produced a deflationary effect in countries which continued to maintain their currencies at their old parities. Thus the world level of prices in terms of gold gradually declined between 1931 and 1935. But for the depreciation of a number of currencies, such a degree of decline in commodity prices in terms of gold would have been inconceivable. The relief was obtained, however, at the expense of the countries which continued to defend their currencies at their old parities.

The devaluation of the dollar by 41 per cent in January 1934 increased the nominal amount of the world's monetary gold stock to no slight degree. It was followed by a number of other devaluations in 1935 and 1936, resulting in the writing up of the book value of monetary gold stocks in Belgium, France, Switzerland, etc.

(7) Increase of Current Output

Simultaneously with the increase thus obtained, there was also a marked increase in the current output. This was due to a large extent to the rise in the price of gold in terms of the currencies of the chief gold-producing countries. Since the cost of gold production did not rise to anything like the same extent as the price of gold, it became profitable to work hitherto unprofitable low-grade ores. There was a strong inducement for the gold-mining companies to accelerate the pace of production. Notwithstanding this, most of them exercised a remarkable degree of moderation, especially in South Africa. Admittedly this was due in part to the special tax imposed on them by the Government, but apart altogether from that, the management of conservative gold-mining companies decided to concentrate on low-grade ores so as to prolong the life of their property. They deferred the exploitation of high-grade ores for times when the margin of profit ceased to be sufficient to enable them to continue the exploitation of low-grade ores. Notwithstanding this, the current output increased from 20,904,000 ounces in 1930 to 35,254,000 ounces in 1936. It is easy to imagine how much more the increase would have been but for the partly self-imposed and partly forced moderation of the South African producers.

As a result of the growth in the current gold output, the total quantity of the world's monetary gold stock increased materially, apart altogether from the bookkeeping increases brought about by devaluations. Between the end of 1930 and the end of 1936 the total published official gold reserves

(excluding the U.S.S.R., which does not regularly publish the amount of its gold reserves) increased from 10,800 million gold dollars to 12,801 million gold dollars of the old gold content. This in spite of the wholesale hoarding which made heavy inroads in the gold reserves of many countries. Thus, while the principal currencies were devalued to the extent of 40 per cent, the world's visible monetary stocks of gold increased by nearly 20 per cent. In addition to this, Exchange Equalisation Accounts held substantial amounts which were not included in the above totals. Moreover, there was an unofficial secondary reserve represented by the large amounts of privately-hoarded gold in Western Europe, which were expected to find their way, sooner or later, into the vaults of Central Banks.

(8) New Maldistribution

There is no doubt that the change compared with the scarcity of 1931 was considerable. At the same time, however, a new maldistribution developed. Between 1931 and 1934 the original maldistribution corrected itself to some extent as a result of the decline in the United States gold reserve and the increase in the gold reserves of a number of European countries. From 1934 onwards, however, a new maldistribution developed, which was much more pronounced than the original maldistribution. As a result of the repatriation of American capital, and of the flight of European funds to the United States, the American gold stock underwent a spectacular increase compared with which its increase during and after the war appeared moderate. Apart from the effect of the devaluation of the dollar on the book value of the gold stock, the actual increase between the end of 1933 and the end of 1936 was more than 60 per cent. Great Britain was also gaining gold during that period, though the extent of her gains was not realised owing to the non-publication of the figures of the gold stock of the Exchange Equalisation Account and owing to the fact that the gold stock of the Bank of England was not written up. On the other hand, there was a heavy fall in the gold stock of the Bank of France, which between the end of 1934 and the devaluation of the franc in September 1936 declined to the extent of some 50 per cent. The gold stocks of Holland and Switzerland registered similar losses. The gold reserve of Italy fell heavily from 1934 onward, while that of Germany virtually disappeared. As a net result of these changes, the discrepancy between the

gold positions of the " Have " and the " Have Not " countries increased considerably. Thus, when we talk about abundance of gold in 1937, it refers to only a small number of countries. In the predominant majority of countries the gold supply was anything but abundant.

(9) Gold and Credit

Long before the increase of the gold output and the revaluation of the gold stocks brought about an abundance of gold, the effect of the gold shortage upon the credit structure had ceased, simply because countries with inadequate gold stocks refused to continue to play the " gold standard game." Whether or not they officially suspended the gold standard, and, if they did, whether they allowed their exchange to depreciate or not, they were no longer prepared to contract credit if their gold stock fell below the statutory proportions. In Great Britain the fiduciary issue was raised slightly in 1931. In Germany and a number of other countries the reserve ratio was allowed to decline well below the statutory minimum limit. Nor did France and other countries which maintained the gold standard allow an outflow of gold to produce its full effect upon the volume of credit. It is true that some recipients of the gold sterilised the influx, which was thus prevented from bringing about a corresponding credit expansion. On the other hand, a number of countries with inadequate gold reserves embarked upon a policy of credit expansion with utter disregard for orthodox rules.

Taking the world as a whole, the volume of credit, which contracted materially during the period of deflation, increased between 1931 and 1937 to a considerable degree, but not to anything like the proportion of the increase in the total value of the monetary gold stocks serving as a basis of the credit structure. It is also necessary to discriminate between the increase in the volume of credit available and the increase in the volume actually used. Countries with abundant gold supplies possessed large idle liquid resources, which were not used for financing trade expansion. It was largely owing to these circumstances that the rise in commodity prices did not keep pace with the increase in the total volume of monetary gold stocks.

(10) Ample Gold Resources

The net result of the change in the gold position was that the world as a whole had a large actual and potential reserve

supply of credit available for financing trade expansion. The main fundamental cause of the slump which began in 1929 had thus ceased to exist. Taking the world as a whole, there was no longer any monetary obstacle to the recovery of trade to its 1929 level or even beyond that. Nor was there any obstacle to a substantial rise in commodity prices, sufficient to reduce the burden of excessive indebtedness. The deadlock caused by the inadequate gold supplies had come to an end. It had become possible to hope that the world would work out its own salvation and that some degree of equilibrium between the volume of fictitious wealth, that of real wealth and that of gold supply would eventually be established. It had also become possible to hope that, thanks to the large and increasing volume of gold, the international disequilibrium between the currencies, and the existence of a huge international floating debt, would no longer present a problem impossible to solve. After all, if there is enough gold, international fluctuations can be taken care of.

Almost for the first time in world history, there appeared to be a chance of an accumulation of a huge reserve of gold far beyond immediate requirements, making it possible to finance trade expansion and to adopt a scientific managed currency based on gold. There was every reason to welcome this development, from the point of view of the general interests of mankind. Instead, a large section of those who are in a position to influence public opinion showed themselves utterly incapable of appreciating the advantages of the change. On the contrary, they took an essentially gloomy view of it and showed themselves incapable of knowing when they were well off. The same experts who between 1927 and 1931 had viewed the gold shortage with concern became alarmed by the abundance of gold, though not until the panic that arose among the general public had drawn their attention to the fact of the abundance. The gold situation developed from scarcity to abundance almost unnoticed by the predominant majority of experts. As for the monetary authorities, in most countries they retained the gold scarcity mentality which had developed in earlier years. Until the eve of the gold scare, few people paid any attention to the fundamental change in the gold situation, which partly explains why most people were inclined to exaggerate the significance of that change when they suddenly realised it.

CHAPTER V

HOW THE GOLD SCARE BEGAN

(1) Boom-like Developments in 1936–7

During the first quarter of 1937 reflation stimulated by rearmament continued unabated. Although Stock Exchanges began to show some hesitation, this was only natural, considering that by the end of 1936 the price of industrial shares discounted to no slight degree a further substantial increase in earnings. The common stocks of leading British industrial undertakings yielded only about 3 to 4 per cent, which could not possibly be justified otherwise than on the basis of the anticipation of a further material increase of dividends. The position was similar in Wall Street. It is no wonder, therefore, that the buying fever of equities came to a halt. On the other hand, the rise in commodities, especially in metals, continued, and assumed a distinctly speculative character. It appeared that stocks were far from sufficient to meet increased rearmament requirements, and prices were soaring in anticipation of a prolonged shortage.

Amidst the atmosphere of optimism, few people paid any heed to pessimistic warnings against the dangers of a speculative boom. After all, the average level of commodity prices was still much below that which prevailed in 1929, which had come to be considered as a normal level. Nor was there any sign of unsound credit expansion or overproduction. In such circumstances even those who held the view that this wave of growing prosperity could not last for ever were convinced that it would be a long time before the inevitable break came.

In such conditions the gold scare, with all its grave repercussions upon stock markets and commodities, came as a bolt from the blue. Even those extreme pessimists who expected a break to occur soon did not expect the blow from that direction. They thought it might be the result of a crisis in the building industry, or of a setback in the armament industry caused by some international agreement for the limitation of armaments. The monetary factor was one

of the strongest bull points in the whole situation, and the trouble that arose from that side was as unexpected as it was unreasonable and unjustified.

(2) The Gold Scare of 1916

The term "gold scare" is new in our financial vocabulary, but the phenomenon which it indicates is by no means new. The world experienced a minor gold scare during the war, when some of the neutral countries, alarmed by the effects of a heavy influx of gold, endeavoured to check that influx. Sweden sought to impose an embargo on gold imports but was subsequently prepared to accept the metal at a reduced price. Spain suspended the import of bar gold, but the Allied Governments overcame this embargo by the discovery that the gold coins of the Latin Union were legal tender in Spain.

Nevertheless, the fact that, probably for the first time in modern history, an influx of gold was considered something essentially undesirable, gave rise to some concern. It induced the Washington Administration to make a feeble attempt to check the British gold shipments to New York. These shipments were undertaken with the deliberate object of creating easier money conditions in the New York markets so as to enable the British Treasury to unload in Wall Street American railroad stocks called in from British holders. Whenever the absorbing capacity of Wall Street became exhausted, so that further sales of railroad stocks would have led to a further heavy fall in their price, the British Government dispatched gold for sale to the Federal Reserve Bank of New York, and this enlarged the volume of credit, thereby creating the wherewithal for buying more railroad stocks. The United States authorities viewed this interference with American monetary policy with concern. Eventually, in 1916, after the practice had been going on for more than twelve months, the British Government was informed that the shipment of more gold to the United States would be regarded as an unfriendly act. Needless to say, it was necessary for the shipments to continue in order that the British and Allied Governments should be able to pay for their purchases from the United States. Since the alternative to gold shipments would have been the cessation of purchases, the Washington Administration did not press the matter any further.

This gold scare of 1916 was more or less confined to official quarters. The American incident took place behind closed doors and nobody but a small number of politicians and

Government officials knew about it. Although the Swedish embargo was a matter of general knowledge, it failed to alarm the public, as the measure was regarded as being purely temporary.

(3) The Gold Scare of 1935

Another minor gold scare occurred early in 1935, while the Washington Supreme Court was deliberating about the validity of Gold Clause legislation. There was a possibility that the Supreme Court might declare that legislation unconstitutional, in which case the situation of debtors would have become most embarrassing. They would have had to discharge their debts by payments in dollars of the old gold content. This would have meant a payment in paper dollars of a surplus of some 70 per cent, which would have ruined the very debtor classes whom President Roosevelt was anxious to help, and would have increased the burden of the largest debtor of all, the Federal Government itself. It was widely assumed that in order to avoid the imposition of this additional burden, President Roosevelt would then restore the dollar to its old gold content.

While the Supreme Court was deliberating, arbitrageurs were anything but keen on shipping gold to the United States, as they did not want to run the risk of a reduction of the American buying price while their consignments were on their way. As a result, the price of gold went to a heavy discount against the American shipping parity. When, however, the Supreme Court eventually decided to uphold the validity of the Gold Clause legislation, the minor gold scare came to an end and normal conditions returned. While it lasted the gold scare was confined more or less to the professional arbitrageurs. It was not accompanied by any wholesale dishoarding of gold, nor by any slump in gold shares or securities.

(4) Vague Fears about Gold Prospects

Apart from these acute gold scares, there has been from time to time a certain amount of vague uneasiness about the ultimate fate of gold. In particular, between 1933 and 1935, entirely unreasonable fears were entertained that, should all countries suspend the gold standard, the price of the metal would undergo a slump. The absurdity of such views—which I examined in detail in my book *The Future of Gold*, published in 1934—was glaringly evident. A suspension of the gold standard means that the monetary authorities are unwilling

to sell gold, and not that they are unwilling to buy gold. The result of an all-round suspension could be nothing but an increased demand for gold, which could no longer be satisfied by drawing upon the official gold reserves. Although this was a matter of common sense, the number of experts and pseudo-experts who held views to the contrary was surprisingly large. Nevertheless, the public in general did not allow itself to be frightened, and even the most alarmist prophecies of Majors Douglas and Angas failed to produce a gold scare. In the meantime, events amply proved that the suspension of the gold standard by the Gold Bloc countries was not a bear point for gold.

The circumstances in which the big gold scare of 1937 arose are well worth examining in detail. Once the gold scare was in full swing, it was widely regarded as the natural consequence of the increase in the volume and value of the world's monetary gold stock. This increase was, however, gradually achieved, as we have seen in Chapter IV. Even though gold production became accentuated during 1936, its figures were available by January 1937, and during the following three months there was no material change in the gold situation; nor did any essential new facts or figures come to the knowledge of the public, which, in fact, took very little interest in gold statistics. I doubt if any of those arbitrageurs, speculators and investors who were originally seized by the gold panic gave any thought to the figures of gold production when they first adopted an extremely pessimistic view about the prospects of gold. They were influenced by totally different considerations.

(5) President Roosevelt and the Gold Scare of 1937

The gold scare of 1937 was the result of the coincidence of a number of circumstances. Amongst them the change in President Roosevelt's attitude towards monetary policy undoubtedly played a prominent part. It was obvious throughout 1936 that the President was drifting towards monetary orthodoxy. Even though his declared goal of restoring prices to their 1926 level was still very far from having been attained, the President appeared to have become afraid of the spirit of reflation which he himself had invoked. He passed a series of anti-inflationary measures. This change of front explains why in 1937 it could enter the heads of a large number of people that he might conceivably adopt a brutal deflationary measure such as a reduction in the American buying price of

gold. Moreover, towards the end of 1936 President Roosevelt declared himself strongly against a further influx of "hot money", and threatened drastic measures against such an influx. Several months passed without any concrete measures having been taken, and the idea got abroad that conceivably what he had in mind was to check the influx of "hot money" by checking the influx of gold. This idea did not assume any concrete form until the acute gold scare began, but it explained in part the readiness with which the public absorbed the gold scare rumours.

Early in March 1937 President Roosevelt made a statement condemning the sharp rise in commodity prices and foreshadowing measures against it. He did not specify what measures he had in mind. A few days later a member of the Administration stated that there would be no question of applying the remedies of higher bank rate and credit restrictions, but he re-affirmed the Government's decision to take strong measures. These statements were probably largely responsible for the origin of the gold scare. Because of them, the remarks dropped subsequently by Professor Sprague on the occasion of his visits to London and Paris, foreshadowing a reduction in the American buying price of gold, found ready believers.

(6) Soviet Gold Exports

Before we deal with the part played by Professor Sprague as an immediate instrument in bringing about the gold scare, we have to deal with another development which occurred almost simultaneously with President Roosevelt's statement. This was the sudden increase of gold exports by Soviet Russia. Until March 1937 there was but little concrete evidence of the much-advertised increase in the gold output of the Soviet Union. The figures of the official gold stock were not regularly published and visible Soviet gold exports were on a modest scale. There is reason to believe that the bulk of Soviet gold exports found its way to Germany, in payment of the German credits to Russia which were not renewed. Some of the gold found its way abroad via Berlin, and was entered in the Customs Returns as gold exported from Germany. In March 1937 it became known, however, that insurance facilities between Leningrad and London had been arranged at Lloyds for gold shipments to the amount of £36 million, to be shipped in Soviet steamers. The consignments began to arrive, and followed one another in close succession. Even though the

whole amount of the facilities was not exhausted—the total of actual shipments at the end of March and the beginning of April was some £26 millions—the arrival of such large amounts of gold from Soviet Russia produced a very profound impression. Its psychological effect was strongly unfavourable, since it created the impression that the Soviet authorities were anxious to unload their gold stock in a great hurry. Nobody had any idea about the size of the Russian gold stock, and it was feared that the total to be shipped would be much larger than the amount originally arranged for.

Fears that one of the leading gold-producing countries intended to demonetise gold gave rise to a certain amount of dishoarding. At the same time the Soviet shipments created a very difficult technical position. It was inevitable that the bulk of the gold should find its way to the United States Treasury in the absence of any other large buyers. Shipping facilities between London and New York were, however, limited, and insurance rates on shipments soared to a fantastic figure. It was not easy to re-ship the gold for New York as soon as it was sold in the London market. Consequently, arbitrageurs became reluctant to undertake purchases unless and until shipping facilities became available. Their reluctance resulted in the disappearance of the premium on gold against the American shipping parity, and on April 6 the price actually went to a small discount.

(7) Professor Sprague's Rôle

By that time, rumours of an impending decision of the United States authorities to reduce their buying price of gold were circulating freely. Although they may have originated simultaneously from several quarters, there is one quarter, at any rate, which can be traced down without doubt. Professor Sprague, during his stay in Europe, repeatedly stated, both in private conversations and in public or semi-public statements, that he believed in the likelihood of a cut in the American buying price of gold. Before long his remarks had been repeated all over the markets, and gave rise to growing concern about the prospects of gold.

It may seem strange that such importance should have been attached to the private views expressed by a professor who, at the time, held no official post whatever. To explain the deep impression created by his remarks, it is necessary to recall, however, that in the past he had held important official positions. Between 1930 and 1933 he was economic

adviser to the Bank of England, and he was a member of the committee in charge of the Exchange Equalisation Account operations. In 1933 he left the Bank of England to join the United States Treasury, and carried on negotiations on behalf of the latter in London during the Economic Conference. In 1934, however, his official position came to an end through his resignation, and since then his activities have been confined to business and teaching appointments. Nevertheless, owing to the frequency of the personal changes in the Washington Brain Trust, many people in London were not quite sure whether he was not still in some way connected with the United States Treasury.

According to reports which appeared in the Press in March 1937, and which were never contradicted, Professor Sprague came to Europe on an official mission. These reports were given an appearance of authenticity by the fact that during his stay in London he used the Bank of England as his address. Although the circumstances of his departure from the Bank in 1933—when he virtually deserted to the enemy on the eve of battle—caused much ill-feeling at the time, evidently he was forgiven and his former office placed a room at his disposal. The fact that he was able to give the Bank of England as his address unquestionably strengthened the impression that he was in London on some kind of official mission. The truth of the matter is that even before he severed his connection with the United States Treasury, he had not been in the confidence of President Roosevelt. In fact, the reason why he resigned was that although he had been appointed Economic Adviser, his economic advice was never asked, and such unsolicited advice as he chose to give in public or in private to the lesser lights of the Administration was not followed. It almost seemed as though he had been asked to join the Washington Treasury not for the sake of his advice on policy—his orthodox views were well known to the Administration, which did not in the least share them—but in order that he might give the Administration an insight into the secrets and mysteries of the Exchange Equalisation Account. For some odd reason the Exchange Equalisation Account had acquired a reputation for being gifted with almost superhuman skill, and since the United States authorities were on the point of establishing a similar account for themselves, it was only natural that they should want the services of one who, besides having acquired a unique experience at the Bank of England, was a citizen of the United States. In all

probability they never meant Professor Sprague to be anything but an instrument to be used and discarded. He was not really even an inside member of the Washington Brain Trust, his views being much too orthodox to qualify him for membership. In any case, in 1934 he left the Government service, and since then his attitude towards the official policy had been decidedly critical.

(8) Effect of Rumours

This digression concerning the relations of Professor Sprague with the Washington Administration was necessary in order to show that, notwithstanding the favour conferred upon him by the Bank of England, there was no reason to regard him as the spokesman of President Roosevelt or Mr. Morgenthau. Possibly but for the vague uneasiness created by President Roosevelt's statement and the Russian gold shipments, his remarks about the likelihood of a cut in the American buying price of gold would have received but scant attention. As it was, they played the part of the spark immediately responsible for the conflagration.

The tension was growing from day to day. Cable followed cable between New York and London, and the American banks, always ready to lose their nerve in an unusual situation, instructed their London offices to abstain from shipping gold. They did so entirely on their own initiative. Nevertheless, rumours got into circulation from the London office of one American bank, suggesting that instructions to that effect had been given on official inspiration. The result was the accentuation of the gold scare. The discount on gold, which had at first been only ½*d.*, widened considerably, and arbitrageurs were reluctant to take gold, even at the abnormally large profits secured by the existence of a big discount. The rumours of the possibility of a cut in the American price of gold, together with the evidence of a large discount, led to wholesale dishoarding, which went on for about three months.

(9) Gold Scare—A Result of Coincidences

A minor factor which may have played some part in bringing about the gold scare was the armistice concluded between the French Socialist Government and French financial and industrial interests, in March 1937. Details of this occurrence will be discussed in a later chapter. Here it is sufficient to point out that the slight improvement in the relations between Government and capitalists gave rise to hopes of a resumption

of dishoarding and repatriation. This factor played, however, an insignificant part compared with the factors mentioned before.

By the middle of April the gold scare was in full swing. The circumstances of its origin should be borne in mind when its developments and consequences are examined in the next chapters. The whole gold scare may well be described as a comedy of errors. It came into existence because President Roosevelt did not know his own mind, and became frightened of the consequences of his own policy; because the Russians wanted to boast of their newly acquired treasure by exporting gold in the most ostentatious manner possible; because of a mistaken impression created by Professor Sprague's visit to London, and the unwarranted importance attached to his remarks. In the absence of these circumstances the gold scare might never have occurred. The fact of the abundance of gold would not have been realised and exaggerated by economists, and would not have received world-wide publicity. Considering the consequences of the gold scare, those responsible for its origin bear a grave responsibility. Fortunately for them, that responsibility is shared among several people, and is not likely to prove unbearable to any of them.

CHAPTER VI

THE GOLD-SCAREMONGERS

(1) How the Gold Scare was kept Alive

Having explained the origin of the gold scare, let us now proceed to investigate the reasons why it remained in existence for a full three months. In the ordinary course, unfounded scares in the financial markets are short-lived. There was no reason why the gold scare should last more than a few weeks. After all, the Russian shipments had come to an end by the middle of April and the Washington authorities issued denial after denial making it plain that they did not in the least intend to lower the price of gold. Notwithstanding this, the gold scare dragged on from April into May, and attained its climax early in June. Throughout that period, large amounts of gold were thrown on the market day after day by hoarders. There was a slump in gold-mining shares creating weak positions which led to selling in other sections of the Stock Exchange and in the commodity markets. It may well be asked why this was necessary, considering that the rumours responsible for the scare were without foundation.

The answer is that the gold scare was kept artificially alive by a large number of scaremongers. I am not suggesting that there was any deliberate conspiracy afoot to that end. The extreme pessimists whose articles, speeches, remarks and whispers were responsible for the prolongation of the gold scare had no connection whatsoever with one another. Some of them were recognised economists of international standing ; others were bankers of local or European reputation ; others again were financial journalists, newspaper proprietors, currency cranks, speculators, etc. Many of them acted on genuine scientific convictions. Others had an axe to grind. The relative share of any one of these scientific, pseudo-scientific or frankly unscientific gold-scaremongers in the responsibility for the prolongation of the gold scare may have been small, but between them they succeeded in keeping the scare atmosphere in existence. Some of them succeeded in accentuating the prevailing uneasiness from time to time into a truly panicky atmosphere.

(2) Rumourmongering

The gold-scaremongers may be divided into two classes. There were those who were spreading rumours about the alleged intention of the American authorities to lower the buying price of gold, or to limit their gold purchases, or any other rumours calculated to accentuate pessimism regarding the gold position and prospects. And there were those who endeavoured to paint the existing well-known factual material about the gold position and prospects in the darkest possible colours. While disclaiming any knowledge of what the Governments intended to do, they were free with their advice to the Governments on what they ought to do, and in prophesying what they would have to do in the long run.

We saw in the last chapter that Professor Sprague had the lion's share of the responsibility for the appearance of the rumours about the likelihood of a decision by the United States Government to lower its buying price of gold. In all fairness to him it must be admitted that he expressed his views on the subject as his own personal views. It was the fault of those who misinterpreted his position, and who attributed to him official connections which he did not possess, that by the time the remarks reached the rank and file of the market they were made to appear as if Professor Sprague had been speaking from inside knowledge. There were, however, others who cannot be exonerated from the charge of spreading false rumours by claiming inside information they did not possess. There was the highly damaging rumour put into circulation by certain American banking circles in London, that the instructions for the suspension of arbitrage shipments from London to New York were received from official quarters in Washington. The same American quarters in London were responsible for originating rumours also during later stages of the gold scare. In fact, in quite a number of cases when it was possible to trace back the rumours to their origin, this name came into evidence. There were, however, many others. It was surprising how many people in Throgmorton Street and thereabouts had close relations with such well-informed personalities as, say, the third cousin of a junior footman at the White House, Washington. If the majority of the cables which were supposed to have been received day by day by these rumourmongers from the other side of the Atlantic were not invented on this side, the cable companies must have benefited to no slight extent by the gold scare.

(3) One-sided and Exaggerated Reports

There were also rumours concerning the alleged intention of the United States Government to stop buying gold. A number of people claimed to possess inside information about the negotiations which were supposed to have been conducted between London and Washington concerning a simultaneous reduction in the price of gold, or a simultaneous limitation of purchases. They claimed to know details about the progress of the negotiations, though the fact that Sir Frederick Leith-Ross was seen in London on the very day when he was supposed to be negotiating in Washington threw some slight doubt upon the reliability of this information. Another crop of rumours referred to the alleged intention of various continental Central Banks to unload their gold holdings. Hardly a day passed without the publication of some report about the increase of the gold output in Soviet Russia or some other country.

Thanks to the clever manipulation of headlines, even the most insignificant facts of this kind succeeded in making the gold-hoarders' flesh creep. But in many instances those who gave publicity to these reports did not consider themselves bound by the limitations of the facts at their disposal. There is a well-known saying, which originated during one of the many mining promoting booms in the past, that there are three degrees of liar: damned liars, bloody liars, and mining engineers. During the gold scare a fourth degree of liar seems to have developed, surpassing even the most sanguine of mining engineers. No crooked mining financier ever exaggerated the significance of the "discovery" of the proverbial sample of ore which he himself had previously planted in the prospective gold field to anything like the extent to which the significance of the alleged new gold discoveries were exaggerated by rumourmongers during the gold scare.

Far be it from me to suggest that all these rumourmongers were prompted by sinister motives. Many of them undoubtedly were. They went short in West Witwatersrand before launching their rumours, and took their profit while the rumours were producing their effect. Others, however, were prompted simply by their desire to make out the strongest possible case in favour of a cut in the price of gold, which they believed to be necessary and inevitable. Even though their intellectual honesty is open to question, their financial honesty is beyond reproach.

(4) A False Axiom

The same may be said about many of those who, instead of claiming any inside information, simply expressed their opinion, on the basis of the existing factual material, that the price of gold should be reduced, or that it would have to be reduced in the long run. Many of the economists who took that line were aware that a rise in commodity prices could quite easily absorb the gold surplus in a number of years. Nevertheless, since they were opposed to a rise in commodity prices and to an expansion of credit which would have become possible on the basis of the increased margin of gold reserves, they began to agitate in favour of a cut in the price of gold. They presented that solution as the natural and inevitable result of the working of the inexorable law of supply and demand. "If there is too much gold, its price must fall," was the substance of their argument. It sounded very axiomatic, and converted many people to the idea of a cut in the price of gold as the natural and only possible solution. What these economists omitted to say was that the price of gold could be lowered not only in terms of the current monetary unit but also in terms of commodities through a rise in the price level, which would, in the long run, solve the question of the gold surplus as effectively as a cut in the price of gold would solve it in the immediate future.

This is not the only reproach that can be directed against the majority of gold-scaremongers. Having made up their minds that a cut in the price of gold was necessary, they set out in the approved fashion to make out the strongest possible case in favour of a cut. To that end they presented the facts of the gold position in the gloomiest possible light.

Between April and June 1937 a number of economists suddenly discovered that the world was suffering from a superabundance of gold. It is very remarkable indeed that although they had possessed all the facts relevant to the gold position since January 1937, it was not until the second quarter of the year that they discovered that the figures for 1936 indicated the existence of a dangerously excessive surplus in the current gold output and the gold stock. Economists, whose job in life is to follow these figures as and when they appear, seem to have missed their significance for months—to be exact, until the layman of the financial market began to talk about a superabundance of gold.

(5) Was Increase of Gold Production without Precedent?

Having been slow in the uptake, these economists sought to make up for lost time by exaggerating the facts as soon as their attention was drawn to them. They did their best to convey the impression that the increase in the gold output between 1929 and 1936 was something entirely without precedent in history. If they had only taken the trouble to look at the figures of the world's gold production during the nineteenth century—figures which are very easily accessible, and which they have no excuse for having overlooked—they would have realised that on at least two occasions the rise in the output during comparable periods was much larger than between 1929 and 1936. During the five years ending 1853, after the discovery of the Californian gold fields, the output increased from 1,813,000 ounces to 7,227,000 ounces. During the nine years ending in 1899, after the discovery of the Rand, the increase was from 5,974,000 ounces to 14,838,000 ounces. And yet, in neither the fifties nor the nineties of the last century was there any defeatism regarding the consequences of this increase. On the contrary, it was almost unanimously welcomed by contemporary financial literature as a highly useful development, and in accordance with the interests of the progress of mankind. Why, then, the excitement about the increase of the output from 19,207,000 ounces to 35,254,000 ounces between 1929 and 1936? On this occasion, it is true, simultaneously with the increase in the output there was also an increase in the price of gold, but even allowing for that, the increase in the currency value of the current output was not greater than during the fifties.

Those who were in a panic about gold production figures during the gold scare simply overlooked the fact that the situation was by no means without precedent. In this respect the Hon. R. H. Brand was particularly to blame. A series of articles appearing under his name in *The Times* in June 1937 literally bristled with an intimidating array of figures, duly impressing the average reader, who would hardly have dared to suspect that, when stating that "the stocks of monetary gold . . . have been slowly [*sic*] accumulated over centuries" the author had presumably omitted to cast even a cursory glance at the statistical evidence of the pace at which the gold stock had actually been accumulated.

(6) Defeatism of Bank for International Settlements

Among the super-bankers who joined in the chorus of lamentations about the gold position and prospects, Dr. L. G. A. Trip, President of the Netherlands Bank and, at the time, also of the Bank for International Settlements, predominated. The annual report of the Bank for International Settlements for the business year 1936–7 contained a chapter entitled "A Year of Mounting Gold Supplies", which was largely responsible for the prolongation of the gold scare. Although the report mentions a few suggested remedies, it is only in order to reject them as impracticable or inadequate. It ends up with warnings to gold producers that it is to their interests to agree to a reduction in the price of gold to a level at which it would remain "continuously useful as a basis of currencies" instead of "concentrating attention on immediate profits" by insisting upon the maintenance of the present price of gold.

If the report had been published under the sole authority of Dr. Trip, or of Messrs. Per Jacobson and Connolly, members of the permanent staff of the Bank for International Settlements, who were largely responsible for elaborating it, it would probably not have created such a pronounced impression. Since, however, the defeatist remarks on the gold position were published under the authority of the bank, they inevitably accentuated the wave of pessimism about the prospect of gold.

As is well known, the Board of Directors of the Bank for International Settlements includes the Governors or nominees of a number of leading Central Banks. It is entirely natural, therefore, that the views expressed in the report should be regarded as representing the official views of the Central Banks concerned. As a matter of fact they were nothing of the sort. Most of the directors did not see the text of the report until it was in print, and while they had to pass the accounts of the bank, they were not even called upon to approve or disapprove of the remarks on the general economic and financial conditions. Those remarks were published on the exclusive authority of the signatory of the report, Dr. Trip.

This, however, was not known to anyone except those closely concerned with the affairs of the bank. The general public had every right to assume, when reading extracts from the report in the Press, that its views on gold were endorsed by all the Central Banks represented on its Board. While the

public has mainly itself to blame for attributing to Professor Sprague's remarks an official character which they did not possess, in the case of the Bank for International Settlements report the responsibility for the misunderstanding rested with that institution. Admittedly, when a storm of criticism was aroused by the report, a statement was issued in Basle affirming that the report had been published on the personal responsibility of Dr. Trip. The spectacle of the world's super-bank disclaiming responsibility for the views of its own chairman, published in its own annual report, was not very edifying. It came about a week after the publication of the report, and even then it did not receive nearly enough publicity to undo the mischief already done.

(7) Money Muddle in Sweden

Next on the list of scientific gold-scaremongers is Professor Gustav Cassel. During the earlier years of the depression, Professor Cassel had adopted a distinctly reflationary attitude. Like President Roosevelt, however, he began at the end of 1936 to be frightened by the consequences of the policy he had advocated. Early in 1937 he came out with a strong plea for the upward revaluation of the Swedish krona in order to prevent the Swedish price level from rising in sympathy with the British price level. The attitude taken by the Swedish Government towards his suggestion is well worth describing, as it may provide some comic relief in an otherwise gloomy chapter. In January 1937 the Swedish Finance Minister made a statement foreshadowing the possibility of a revaluation of the krona. It should have been easy to foresee the effect of such a statement. The Swedish banks and other holders of foreign currencies dumped their holdings upon the Riksbank for fear of an exchange loss through the revaluation of the krona. At the same time there was a fair speculative buying of kronor, and an influx of foreign funds, further swelling the already unduly large gold stock of the Riksbank. This was the last thing the Swedish Government wanted, and a few days later it made a reassuring statement rejecting the idea that it had contemplated a revaluation of the krona. Thereupon, official or semi-official statements appeared at frequent intervals concerning the Government's attitude towards revaluation, and on the whole the rule appears to have been followed that on odd dates the idea was rejected, while on even dates it was encouraged.

(8) SPRAGUE *v.* SPRAGUE

Meanwhile, Professor Cassel continued to hammer away at the suggestion, coupling it with a growing display of pessimism concerning the gold position in general. When in April it was reported that Professor Sprague intended to pay a visit to Stockholm, it was freely anticipated that the concerted offensive of the two veteran economists would eventually overcome the hesitation of the Swedish Government, which might then repeat its gesture of an embargo on gold imports, which during the war had given rise to a minor gold scare. The report of Professor Sprague's Stockholm visit proved to be a false alarm, or possibly the attacks in the Press on Professor Sprague induced him to change his itinerary, and even the views which he expressed. While in an address to the Paris Chamber of Commerce in April Professor Sprague declared a cut in the American price of gold inevitable, when he addressed the American Chamber of Commerce in Berlin in the following month he admitted that a cut would not solve the problem of excessive gold supplies in general and the excessive gold stock of the United States in particular. From that time onward, Professor Sprague faded into oblivion as far as the gold problem was concerned. On his return journey he stayed in London for a while, but took great care not to express any opinion for or against a cut in the price of gold.

(9) CASSEL *v.* CASSEL

Professor Cassel, on the other hand, continued his anti-gold campaign. It reached its climax with the publication of an article in the *Daily Mail* on June 9. In this article he surpassed himself in painting the gold position and prospects in the gloomiest possible colours. He concluded with the contention that a cut in the price of gold to half-way between its present price and its pre-1931 price was the only possible way out. The article began with an attack on President Roosevelt for having failed to realise, when devaluing the dollar by 41 per cent, that in doing so he would let loose a cataract of superabundance of gold. The devaluation of the dollar took place in January 1934, and a careful search among the articles published by Professor Cassel at that time fails to reveal any indication that he himself foresaw the consequences of that devaluation upon the gold position. On the contrary, even as recently as July 1936, he showed no

sign of having realised the change in the gold position. An article appearing in the quarterly review of the *Skandinaviska Kreditaktiebolaget* contained the following remarks: "There seems to be a general idea that the recent rise in the output of gold has been on such a scale that we are on the way towards a period of immense abundance of gold. *This view can scarcely be correct*" (the italics are mine). Admittedly, Professor Cassel is not the only one who failed to realise at that time the rapid growth of gold production. But this being so, he is hardly qualified to criticise President Roosevelt for having failed to foresee that development two and a half years earlier. His attack on President Roosevelt is about the worst example of jobbing backwards which has been produced in recent years.

(10) Brand *v.* Brand

The result of Professor Cassel's article was a temporary revival of the gold scare on the day of its publication, although by that time the movement was definitely on the decline. A week later, three articles appeared in *The Times* of June 16, 17 and 18 under the name of Mr. Brand. By that time, the gold scare was definitely drawing near its end. Had the articles been published a few weeks earlier, they would undoubtedly have produced a spectacular effect. As it was, they fell hopelessly flat, partly because a wicked financial journalist took it on himself to steal Mr. Brand's thunder, and warn the markets that the last article in the series would advocate a drastic cut in the gold price. Forewarned is forearmed, and when on June 18 Mr. Brand came out with his world-shattering suggestion of a cut in the price of gold by international agreement, the markets paid but little heed to it. This was possibly because towards the end of his article Mr. Brand reversed the gear—it is said, because of the representations made to him from various influential circles urging him to abstain from causing a revival of the gold scare—so that most readers of the article were not quite sure whether he was actually as keen on the cut as he had appeared at the beginning of the article, when he advocated the systematic preparation of public opinion for the operation. Incidentally, Mr. Brand mentioned France among the countries which would or should or could reduce their official price for gold. Less than a fortnight after this suggestion appeared, the French Government raised quite substantially its official buying price for gold.

Another sequel to Mr. Brand's article came in December,

when he addressed a Back Benchers' committee in the House of Commons on the gold standard. The address was private, and was not reported. *The Times*—of which Mr. Brand is, incidentally, a director—published a paragraph stating that the address had substantially followed the lines of Mr. Brand's articles published in June. As far as I have been able to ascertain, however, in December Mr. Brand certainly did not advocate a cut in the price of gold, which was, after all, the most important point in his articles.

The gold-scaremonger economists and super-bankers are open to criticism for the ease with which they allowed themselves to be flustered into panic-mentality. The ordinary man looks towards them for guidance and has every right to expect them to see beyond the next contango. Brokers, investors, speculators and others in immediate contact with the markets could not help coming under the influence of the surface developments of the moment. They are always apt to assume that the tendency or movement which happens to be afoot will continue for ever. It is for the advisers of the public to rise above this market mentality and regard the boom or scare in its true perspective. Economists and intellectual bankers ought to have guided market opinion instead of having been guided by it.

(II) Mr. Hawtrey's Consistency

Among the economists, there is only one who was consistently pessimistic about the gold prospects. Ever since 1934, Mr. R. G. Hawtrey has held the view that the increase of the world's monetary gold stocks through the increase of the output and through devaluations would lead to excessive inflation, to avoid which the Governments would eventually decide to revalue their currencies. During the gold scare, Mr. Hawtrey must have been strongly tempted to point out that his forecast was coming true. He refrained, however, from indulging in the satisfaction of "I told you so," presumably because he realised that the gold scare was, even on the basis of his views, to say the least, premature. Whether or not we agree with his views about the gold prospects in the long run, the self-control he exercised when so many of his fellow-economists lost their heads is certainly worthy of the highest praise.

The way in which a large proportion of economists allowed market influences to guide their views in fundamental problems has gone far towards discrediting economists in general

in the eyes of the public. Nor did the suddenness with which they changed their attitude once the gold scare was over contribute to a restoration of the prestige of economics and economists. Some of them, like Professor Cassel, at least made an attempt to retreat gracefully. In an article appearing in the October issue of the quarterly review of the *Skandinaviska Kreditaktiebolaget* he admitted that there was no likelihood of the Governments following his advice, though he repeated that they *ought* to have followed it. Most other gold-scaremongers were content, however, to remain silent, assuming that this was the best way to live down what they now realised to have been a first-class blunder. Just as the gold problem did not exist for them until speculators and similar sub-men discovered it, so it ceased to exist the moment the multitude of sub-men lost interest in it.

CHAPTER VII

THE OFFICIAL ATTITUDE TOWARDS THE GOLD SCARE

(1) Half-Hearted Denials

We saw in the last chapter how bankers and economists reacted to the gold scare. Let us now examine the attitude of politicians and administrators. If it is true that, but for the scaremongering of bankers and economists, the gold scare would never have assumed spectacular proportions, and would not have dragged on for three months, it is equally true that, but for the attitude taken by politicians within or outside Governments, high Civil Servants and Central Bank officials, the scaremongering would have produced but a limited effect. It was because of the absence of any evidence of determination on the part of the authorities of this country and of the United States to kill the gold scare that the latter was able to remain in existence throughout the second quarter of the year.

In the first place, the Washington authorities did not immediately deny with sufficient emphasis the rumours about an impending cut in their official buying price of gold or a limitation of American gold purchases. The denials were somewhat belated, and when they came they appeared to be somewhat half-hearted. For a long time they were not watertight. The wording of the denials always left some scope for fresh rumourmongering, and rumourmongers displayed praiseworthy ingenuity in taking advantage of the flaws. Admittedly, after the experience of recent years, when important monetary changes were brought about very soon after official disclaimers of any intention of bringing them about, many people were in any case unwilling to take official denials at their face value. Even allowing for this, it would have been possible to keep the situation under control with the aid of timely and watertight denials. When the statements were issued their wording was so obviously loose that, apart altogether from any rumourmongering, they conveyed the impression that the Washington Administration did not wish to burn its boats.

(2) Loopholes for Scaremongers

Thus when President Roosevelt denied any intention of reducing the buying price of gold, he failed to make it plain that this denial was not confined to the immediate future. When the exploitation of this loophole gave rise to a fresh burst of selling of gold and gold-mining shares, then the Administration went further by stating that the idea of a cut in the price at any future time was not considered. Thereupon, rumourmongers busied themselves by pointing out that what the Administration intended to do was not to make a straightforward cut in the price but to increase the handling charge from $\frac{1}{4}$ per cent—in itself an unreasonably high figure—to a high percentage. This, too, was denied in due course, upon which the rumourmongers resorted to spreading stories about an impending imposition of an import duty on gold. After the issue of a reassuring statement in this respect, together with an assurance that the Washington Administration considered it against the interest of the United States to restrict the import of gold, the scope of rumourmongering became materially reduced. It may well be asked why such an efficiently-worded denial could not have been issued immediately after the beginning of the gold scare.

(3) A Deliberate Policy?

The inefficiency with which Washington denied the gold scare rumours was subject to much criticism. According to one theory, however, there was method in their madness. The gold scare was allowed to spread without undue resistance because it was widely expected to check the speculative boom, thereby obviating the necessity for the Washington Administration to take drastic action to that end. It was even suggested that the Washington authorities were themselves responsible for the initiation of the rumours, but there is no evidence whatever in support of this suggestion. On the other hand, it seems probable that, at the beginning at any rate, the rumours were not altogether unwelcome in official American quarters. They helped President Roosevelt out of a rather awkward situation. It would have been most unpopular for the Administration to take actual deflationary measures in order to check the boom. President Roosevelt was confronted with the dilemma of allowing the boom to continue or checking it with one or other of the unpopular deflationary devices. As it was there was no need for him to act. The rumourmongers

did all the dirty work for him. When it was found, however, that the effect of the gold scare was more than he had bargained for, the Administration made an effort to check it by issuing increasingly emphatic denials.

The United States authorities did not, however, go out of their way to check the gold scare beyond denying their intention of cutting the price of gold or restricting gold imports. They could easily have killed the gold scare with one stroke by accepting delivery of gold in London, or by making arrangements with the British authorities for the latter to buy in unrestricted volume on official American account. They did not, however, wish to do so, for they felt that this would release the British authorities from their share of the responsibility for absorbing the gold thrown on the market. Therefore they did not go beyond eventually issuing watertight denials.

(4) Efforts to Rush Governments into Lowering Gold Price

After the publication of those denials there was no further reason why the gold scare should continue at all. Unfortunately, rumourmongering by market operators was followed by some high-class gold-scaremongering of a different kind. Although those economists and super-bankers who indulged in fostering pessimism regarding the gold position and prospects were prompted by entirely disinterested motives, their activities were no less mischievous in result than those of the shady speculators engaged in spreading false rumours at the earlier stages of the gold scare. While the rumours referred to the immediate future, the views expressed by the high-class gold-scaremongers referred to the more distant future. Without claiming any inside knowledge of what the Governments intended to do, they argued that a cut in the price of gold would in the long run be inevitable. On this assumption they urged the Governments—especially the United States Government—to act now rather than wait until a further accumulation of gold stocks increased their ultimate losses through the eventual cut. Having become flustered in the panicky atmosphere, they did their utmost to rush the Governments into precipitate action. Possibly some of them really believed that it was vital to cut the price of gold without further delay. At least one or two of them, however, must have been fully aware of the temporary nature of the gold scare, and urged immediate action because it was a case of "now or never".

Unless the Governments could be frightened, bullied or blackmailed into cutting the price of gold immediately, the gold scare might subside and the psychological moment for such a delightful deflationary masterstroke would never recur.

We have already seen in the previous chapter the rôle played by some of these high-class gold-scaremongers. Their efforts resulted in a strong feeling of uneasiness about the distant prospects of gold. A number of holders of gold, without believing in the likelihood of an immediate cut, felt it safer to liquidate their stocks rather than wait.

(5) Exchange Equalisation Account's Gold Purchases

Day after day gold running into millions of pounds was thrown on the London market. There was no reason why the whole amount should not be taken for the United States, since the Washington Treasury was prepared to buy an unlimited quantity at a fixed price. Arbitrageurs, however, also came under the influence of the gold scare, and were reluctant to take big risks. The amount of their purchases for shipment to New York was much smaller than the amount sold by hoarders. On days when there were no mail steamers available, there was no demand for arbitrage. But for British official purchases, the London price of gold would have fallen to a very heavy discount against the American shipping parity. This would have brought about a first-class panic in every section of the financial markets.

Fortunately, from the very outset the Exchange Equalisation Account was prepared to buy the gold which was not bought by arbitrageurs. Thanks to this, a major disaster was averted. Nevertheless, the official British attitude towards the gold scare is open to much criticism. It may well be asked why the Exchange Equalisation Account, having decided to buy up the gold which had no other buyers, did not keep the price in the vicinity of the American shipping parity. Suggestions that the price was allowed to go to a discount in order that the Exchange Equalisation Account should be able to obtain the metal at a somewhat cheaper rate may be dismissed, although instances have been known in which the authorities, consciously or otherwise, allowed their policy to be influenced by such petty considerations. According to another theory, their reluctance to maintain the price at the American shipping parity was due to their unwillingness to relieve the Washington Treasury of the necessity of acquiring its due share of the dishoarded gold. If the discount had been kept down to a

nominal figure, no arbitrageurs would have undertaken to ship gold to New York during the gold scare, and the whole amount of dishoarded gold would have had to be taken up by the Exchange Equalisation Account.

(6) A Mistaken Policy

If this interpretation of the official attitude is correct, it shows an utter lack of understanding of the psychology of hoarders, and also of the working of the exchanges. It was largely the evidence of the wide discount on gold that frightened a large number of hoarders into liquidating their stocks in haste, long after the rumours of an immediate cut in the price of gold had become discredited. Had the price been kept down in the vicinity of the American shipping parity, the volume of dishoarding would have become much smaller in May and June. It is true that practically the whole amount would have had to be taken up by the Exchange Equalisation Account, but even so it would have had to buy less than it actually had to buy during the second quarter of 1937.

Moreover, such one-sided buying of gold by the British authorities would inevitably have reacted upon the sterling–dollar exchange. Sterling would have depreciated and would have had to be supported by sales of gold to the United States. In the end the bulk of the gold acquired would have been passed on to the United States authorities. As it was, both British and American authorities were buying gold, and the fact that, notwithstanding the rumours of an upward revaluation of the dollar, sterling appreciated materially against the dollar showed that the British authorities did not buy their due share.

(7) Effect of British Official Attitude upon American Opinion

The evidence of British reluctance to buy gold created considerable ill-feeling in Washington at a time when it was highly important, from a financial, economic and political point of view, that the two Anglo-Saxon nations should display a united front. American political circles and public opinion became irritated by the fact that although the British Empire was the largest gold producer, the British authorities were not doing their due share in absorbing the gold surplus. Various leading American politicians, publicists and political groups expressed their disapproval of the British attitude in violent terms. Needless to say, they presented the case against the

British attitude with gross onesidedness, overlooking the fact that the United States, as by far the biggest holder of gold, and one of the biggest producers, has at least as much at stake in maintaining the price of gold as the British Empire.

Ever since the War of Independence it has always been popular in the United States to present the British as the villains of the piece, and there was no lack of politicians indulging in cheap demagogy and trying to make political capital out of abusing the British for their attitude towards the gold scare. Among others, the Banking and Currency Committee of the Republican Party issued a manifesto which provides a classic example of ignorance and/or malevolence. It was very fortunate indeed that the gold scare came to an end by the middle of the year, for if it had continued for many months more it would have thoroughly poisoned the mind of the American nation towards Great Britain. All this because of the incredible short-sightedness of a few Treasury and Bank of England officials responsible for shaping the policy of the Exchange Equalisation Account.

(8) Criticism in Parliament

The attitude of the Exchange Equalisation Account towards the gold scare was subject to much criticism both in the Press and in the House of Commons. Mr. Robert Boothby and other Members of Parliament who realised the broader implications of such a technical point as the discount on the American shipping parity, did their best to urge the Chancellor of the Exchequer to make a gesture displaying determination to uphold gold in the face of the attacks on it. They succeeded in eliciting from the Treasury Bench some half-hearted assurances, but were privately told that the Government was anxious not to reassure the public too much, for fear that it should give rise to a revival of the boom. Nor was Sir John Simon—who was at the time new to the Treasury and was incredibly badly advised on the subject—prepared to change the tactics of the Exchange Equalisation Account.

In face of the insistence of several Members of Parliament, certain quarters resorted to a counter-stroke by putting up several Members of Parliament to urge the adoption of the opposite policy, namely the complete cessation of gold purchases. The mere idea that Great Britain should deliver such a blow to the gold-producing Dominions was fantastic, and yet there were politicians willing to associate their names with such suggestions. The result was that agitation in the House

of Commons in favour of gold and against it more or less cancelled itself out. Realising the futility of it all, the politicians concerned eventually called a truce and undertook not to ask any more questions either in favour of a more effective gold policy or in favour of the opposite course. Since the Press was also divided on the question, there was no adequate pressure to force the Government to abandon its somewhat ambiguous attitude and to correct the mistaken tactics of the Exchange Equalisation Account—tactics which might easily have produced disastrous consequences.

(9) Muddling Through

While originally the gold scare had no justification, thanks to official mismanagement it might easily have created its own justification if it had led to a universal flight from gold. In itself the wholesale dishoarding of Western private gold hoards did not constitute an intolerable burden. It was evident all along that sooner or later these hoards would have to be taken up in any case by the Central Banks. The danger was that the gold scare might lead to a flight from gold also in the East, and that it might even induce a number of Central Banks to unload their reserves upon the United States. If this had happened on a large scale, the pressure of American public opinion would have compelled Congress and Administration to take precipitate action which they might have regretted ever after. Fortunately there was no evidence of any large dishoarding in the East, and among Central Banks there were only a few rats who deserted what they then thought was a sinking ship. One or two continental monetary authorities converted part of their gold stocks into dollars, an action which was unpardonable in the circumstances. Since, however, most Central Banks kept their heads, the short-sightedness of the British monetary authorities did not produce the fatal consequences which it might easily have produced. They had, indeed, more luck than they deserved. As has happened so often in history, Great Britain muddled through somehow.

In all fairness it ought to be recognised that while the tactics adopted by British and United States Governments during the gold scare were deplorable in their inefficiency—the gold scare came to an end *in spite of* these tactics, not because of them—their fundamental policy deserves the highest praise. Neither President Roosevelt and Mr. Morgenthau nor Mr. Chamberlain and Sir John Simon allowed themselves to be frightened into following the unsolicited advice of so many economists and

super-bankers to cut the price of gold, or the equally unsolicited advice of politicians and currency cranks to limit their gold purchases.

(10) Mr. Keynes's Advice

Amidst the panicky atmosphere of the gold scare the statesmen kept their heads. They followed Mr. Keynes's advice to " wait and see." It was unfortunate that during the greater part of the gold scare a grave illness prevented Mr. Keynes from playing an active part in the controversy. His sole contribution to the gold scare debate was a letter, written from his sick-bed, appearing in *The Times*, the substance of which was the common-sense suggestion that Governments should await the further development of the gold situation before taking irreparable action. Obviously this was the voice of reason. The additional losses which the Treasury might have incurred by waiting would have amounted to a mere fraction of the losses which they would have inflicted upon themselves, their country and the world in general by acting immediately. The risk attached to waiting for a few years to see how the situation adjusted itself was negligible compared with the tremendous immediate losses through immediate action. As usual, Mr. Keynes was right. While in the past his advice had often been disregarded by the Government—though on almost every occasion they had reason to regret it—this time they followed it. By adopting a sound line on the fundamental issue, the two Governments have succeeded in muddling through, notwithstanding their grave errors of detail.

CHAPTER VIII

THE END OF THE GOLD SCARE

(1) Effect of the Gold Scare

For three full months the financial markets and commodity markets were under the cloud of the gold scare. During that period, gold amounting to well over £100 million was dishoarded in London alone. In some instances, gold acquired for jobbing purposes was sold at a loss, but since the majority of continental hoarders had acquired the metal before the devaluation of their national currencies, they were able to liquidate their holdings at a substantial profit in spite of the discount on the American shipping parity. As for arbitrageurs, they had the time of their lives, especially if they had the courage of their convictions. It is not often that they have a chance to make a margin of profit on gold shipments amounting to between 4*d*. and 7*d*. per ounce of gold. Usually they are quite satisfied with a profit of ½*d*. or less. In itself the gold market did not, therefore, suffer very much through the gold scare, although the sleepless nights caused by the imaginary risk they took may have shortened the lives of some arbitrageurs. It was outside the gold market that the gold scare produced its most destructive effect.

The market in gold-mining shares was the first to suffer. The extent to which the capital value of gold-mining shares would have been affected by a cut in the price of gold was, of course, many times larger than the direct effect of a cut upon the price of gold itself. If the margin of profit of a gold-mining company was, say, 15 per cent, a cut in the price of gold by 20 per cent would have converted a handsome profit into a substantial loss. It was therefore natural that fears of a cut in the price should result in heavy realisations of gold-mining shares. The shares of companies which had not yet proved their worth, or which depended upon the working of low-grade ores, were, of course, the chief victims. There was a heavy slump in the market of Kaffirs in London, and in Johannesburg. The latter market had for years been the scene of reckless speculation in gold-mining shares. Most

speculators bought large amounts with very inadequate margins, so that the slightest setback in the price led to forced liquidations. When the gold scare resulted in a heavy fall, many speculators and brokers got into difficulties. The disaster would have been greater but for the intervention of financially strong quarters which were prepared to assist and carry some of the victims. Thanks to this the number and extent of open failures was remarkably small.

The slump did not confine itself to gold-mining shares: it spread over practically every section of the Stock Exchange. This was due to the forced liquidations in connection with losses suffered on gold-mining shares, and also to the anticipation of the deflationary effects of a cut in the price of gold. The latter factor also affected commodity prices, and the upward trend which had prevailed during the first quarter of the year became reversed.

(2) Why the Gold Scare Ended

Temporary respites and reactions apart, this adverse movement continued until the beginning of July. Towards the end of June conditions became distinctly better and there was evidence to show that the gold scare was drawing near its end. It came to an end early in July, when the discount on gold disappeared and dishoarding virtually ceased. This was far beyond the most optimistic expectations. Even those who refused to be influenced by the gold scare mentality felt that the cessation of the acute gold scare would be followed by a prolonged period of vague fears, and that from time to time the acute panic would recur. Instead, the gold scare, whether acute or chronic, came to an abrupt end in July, and has not recurred up to the time of writing.

The main immediate factor responsible for terminating the gold scare was probably the revival of the franc crisis. We saw in Chapter V that the appearance of moderate optimism about the prospects of the franc, following upon the truce in March 1937, between the Government and the capitalists, contributed to some slight extent to the gold scare, and that, conversely, the gold scare itself strengthened the position of the franc. The better tendency of the franc proved, however, short-lived. The " armistice " was broken by both sides and by June the fight was resumed. The franc once more came under strong selling pressure, which began to assume sweeping proportions towards the end of June.

Throughout the financial history of recent years it has often

been noticed that adverse pressure on one particular country or market may cease, not because of any improvement in that country or market, but because attention is diverted from it. Thus in October 1931 sterling underwent a passing recovery because there was a sudden wave of pessimism regarding the dollar. Again in May 1935 the flight from the Swiss franc and the Dutch guilder came to an abrupt end thanks to the development of a flight from the French franc. In June 1937 the flight from gold and gold-mining shares came to an end largely because of the development of a flight from the franc. The change in the French situation led to the termination of dishoarding by French holders, and even to the anticipation of a revival of hoarding. To a large extent the attention of financial circles became diverted from gold to the franc.

(3) Exchange Equalisation Account's Additional £200 Million

Another factor which had an important share in bringing the gold scare to an end was the arrangement made by the British Government to increase the borrowing power of the Exchange Equalisation Account by £200 million. This arrangement was interpreted as a gesture indicating that the British authorities were prepared to continue buying up large amounts of gold, a fact which went a long way towards restoring confidence in gold. It is possible that the Bill submitted to Parliament to increase the sterling resources of the Exchange Equalisation Account pursued the object of producing a reassuring effect. Otherwise the sterling requirements of the Exchange Equalisation Account could have been satisfied equally well by a gradual reduction of the fiduciary issue of the Bank of England. This was actually done in December 1936, when in order to provide new sterling resources for the Exchange Equalisation Account the fiduciary issue was reduced by £60 million to £200 million. Thus Government securities to the amount of £60 million became available for the use of the Exchange Equalisation Account. There was no reason why the remaining £200 million of the fiduciary issue should not be used in the same way. This could have been done by administrative action, and the Government would have saved itself the trouble of passing a bill. Although the Government was anything but keen on facing a lengthy debate on its monetary policy, which was inevitable if the House of Commons was asked to provide an additional £200 million, it resorted, nevertheless, to this method, presumably

in order to provide the much-needed gesture of reassurance for the benefit of gold.

(4) Improvement of Technical Position

The improvement of the technical position as a result of the reduction of private gold hoards in Western Europe must also have produced a reassuring effect. Even though private hoards in London and elsewhere were still substantial in July, they were but a fraction of their maximum level attained prior to the devaluation of the franc, and they were also considerably below their pre-gold scare figures. No statistical data were available, but most banks maintained that the gold stocks which they held on account of their customers had declined by something like 75 to 80 per cent compared with their maximum amount. What was left was not liable to dishoarding to any larger extent. It consisted for the most part of small holdings; or it represented a small fraction of the total wealth of its owners, who preferred to keep part of their capital in gold in order to spread their risk; or it was owned by people resident in countries with exchange restrictions, who dared not give their bankers instructions to sell the gold for fear that these holdings might be traced through the interception of correspondence. However it may be, the volume of dishoarding grew smaller and smaller in the course of the second half of June—its maximum figure was reached early in June, when some £7 million were sold at the fixing on one single day—largely because the amount available for dishoarding declined. The realisation of this fact in itself produced a reassuring effect. Many people who had refused to believe that the United States authorities were considering a cut in the price of gold were afraid that the continuous heavy dishoarding might force their hand. Thus, when dishoarding abated they felt that there was no longer any risk of a reduction in the price of gold.

(5) Disappearance of Original Causes of Gold Scare

Above all, the complete absence of confirmation of the rumours that the United States authorities were considering any measures calculated to lead to a fall in the price of gold, gradually produced a reassuring effect. Even those who were not prepared to rely upon official denials gradually realised that, strange as it might sound, the authorities meant what they said. The crop of denials issued in April were beginning to produce their effect in June and July.

Moreover, the Russian gold shipments which contributed to a considerable degree to the origins of the gold scare did not continue to any noteworthy extent. Partly as a result of the evidence of strong anti-Soviet feeling which these transactions had brought about in Great Britain and the United States at a time when Moscow was particularly anxious to be on good terms with those countries, and partly from fear that some measures might be imposed to restrict the purchase of Russian gold, the Soviet authorities reduced their shipments to normal proportions. They also made arrangements by which their shipments were no longer sold in the open market but were taken over by the British or American authorities. Had this been done from the outset, the adverse effect of the large shipments upon the technical position might have been obviated. This instance shows that co-operation between the Governments in this sphere could do much to smooth things out. The bogy of a flood of Russian gold was also becoming discredited. There were rumours, as yet unconfirmed, that there was a setback in the gold output in the Soviet Union, and even that the figures for 1936 had been somewhat exaggerated.

(6) Cessation of Boom

Last, but by no means least, the cessation of the boom also contributed towards removing fears of American action leading to a fall in the price of gold. The reason why the gold scare rumours found such a fertile soil was the assumption that President Roosevelt might resort to a cut in the price of gold in order to check the boom. Now that there was no boom to check, the reason for deflationary action of any kind no longer existed. In well-informed circles in Washington, it was said that the Administration was delighted with the course of events. Even though it may not have been true that the gold-scare rumours were deliberately launched into circulation by the American authorities, the effect of the rumours upon the boom certainly put ideas into the heads of officials in Washington. There was a school of thought which believed that the weapon of the gold scare would represent a useful addition to the armoury at the Treasury's disposal for the control of the trade cycle. According to their doctrine, whenever there was a danger of a speculative boom, the authorities would only have needed to drop a few ambiguous hints about drastic measures, leaving it to the gold-scaremongers to do the rest.

As a result of the joint effects of the factors enumerated

above, by the middle of July the gold scare was regarded as a thing of the past. While many people believed that sooner or later we might witness a revival of the scare, the fact that the private gold holdings in Western Europe had become reduced to within manageable proportions went a long way towards giving rise to the view that future gold scares, if they should arise, would be of a more moderate dimension.

PART III

THE TRAGI-COMEDY OF THE FRANC

CHAPTER IX

A MISMANAGED DEVALUATION

(1) The Franc and World Finance

Developments in the foreign exchange markets have been of exceptional interest ever since 1931. During 1931 and 1932 the movements of sterling monopolised the world's attention. In 1933 and 1934 its rôle as the principal hero (or villain ?) of the monetary drama was taken over by the dollar. The latter then relinquished its rôle to the franc, which, during 1935 and 1936, was the centre of interest. The vicissitudes of the franc were followed with keen attention throughout the civilised world, as its fate was rightly expected to produce repercussions far beyond the borders of France.

After its devaluation, the franc ceased to occupy the same central position in the international financial picture. Its subsequent fate came to be regarded as being largely the concern of France herself. Even though the further depreciation of one of the major currencies must inevitably produce international repercussions, these were not expected to be of vital importance. Nevertheless, the various phases of the struggle of the franc from October 1936 onward were followed with much attention in foreign financial centres, although this attention was from time to time diverted to other phenomena.

(2) M. Blum's Mistake

The vicissitudes of the franc during the six months that followed its devaluation were described in detail in my book *World Finance, 1935–1937*. Nevertheless, for the benefit of those readers who have not read that book, I propose to summarise briefly the outlines of developments during that period. The experience of the franc provides an instructive example of the mismanagement of devaluation. It has taught us that while devaluation is calculated to provide instantaneous relief if the difficulties of a country are due to an overvalued currency, the operation need not necessarily be successful. Nor is it in itself sufficient to solve all problems. While in the case of Belgium, Holland and Switzerland, devaluation was an

unqualified success, in the case of France it was a failure. The reason was partly that it came too late and was not sufficiently substantial, and partly that amidst the conditions then prevailing in France, no devaluation, however efficiently managed, could have been made to succeed.

There can be no excuse for the delay in the devaluation of the franc. Had it been carried out at the beginning of June 1936, immediately after M. Blum assumed office, it might have obviated the ugly developments during the early period of the Front Populaire régime, when the reluctance of employers to grant wage increases was overcome by force with the aid of an epidemic of stay-in strikes. Employers could hardly be blamed for being unwilling to grant increases of wages when, owing to the rigidity of the franc and the high prices already prevailing in France compared with the world level, they stood but little chance of passing on to the consumer the increased cost of production. Had M. Blum devalued the franc on the first day of his term of office, employers would have been more willing to come to terms with labour, and the necessity for the use of force might have been obviated. It took nearly four months, however, for M. Blum to make up his mind, and meanwhile he was making an absurd attempt to square the circle by pursuing an economic, budgetary and social policy making for a sharp rise in commodity prices, and a monetary policy resisting the natural effect of such a rise upon the international value of the franc.

The explanation of M. Blum's attitude in this matter and in financial matters in general during the months that preceded and followed the devaluation of the franc lies in his utter contempt for finance. He grossly underestimated the importance of that factor, which he considered a matter of technical detail. He believed that he could afford to disregard any disagreeable financial developments while his mind was preoccupied in the loftier regions of social reform. The financial factor could not, however, be disregarded with impunity, and before long M. Blum was forced to take notice of it. By September, 1936, he had realised that it was no longer possible to defend the franc, and devaluation was decided upon.

(3) Inadequate Devaluation

In itself the mischief caused by unnecessary delay was not impossible to remedy, if only devaluation had been carried out in a way and in circumstances favourable for its success. The experience of other countries has proved that it is possible

to recover through a successful devaluation, from the effects of a prolonged defence of a currency at an overvalued level. Unfortunately, when devaluation was decided upon, its extent was kept down to a bare minimum. The explanation lay partly in the desire to keep down the rise in the cost of living. To that end the rate of stabilisation was fixed at a figure at which it barely allowed even for the direct effect of the devaluation itself upon the price level, let alone the effects of the application of the 40-hour week and other social legislation. The devaluation of the franc by 30 per cent restored it more or less to equilibrium, but it was hardly reasonable to expect the state of equilibrium to continue for any length of time.

It was also a mistake to fix the legal limit of the value of the franc between 25 and 35 per cent below its former level, instead of devaluing it definitely to the extent of 30 per cent. As a result, the actual devaluation by 30 per cent was generally considered provisional and everybody expected a further downward adjustment to its lower legal limit. This technical consideration, together with the inadequate degree to which the further rise in French commodity prices was provided for, went a long way towards foredooming the French devaluation to failure.

(4) Anti-Capitalist Measures

Moreover, M. Vincent Auriol took the opportunity afforded by the devaluation to indulge in anti-capitalist measures, by imposing a 100 per cent tax on profits derived from the devaluation by holders of gold. Although there may be moral justification for such a measure, from a practical point of view it was a grave error, since it discouraged dishoarding and repatriations. But for this measure there would have been a sweeping movement of dishoarding and repatriation during the first months that followed the devaluation of the franc. As it was, the amount of capital that left its hiding-place was comparatively small, and was not sufficient to enable the French authorities adequately to strengthen their technical position.

Above all, the political attitude of the Government and of the rank and file of its followers was such as to preclude the possibility of a successful devaluation. M. Blum could well have afforded to call a truce in his measures of social legislation, which, however justified they may have been, were a direct challenge to the wealthy classes. After all, the batch of measures which he passed before Parliament adjourned in

July was very impressive indeed, and he might have rested on his laurels. The Government considered it necessary, however, to satisfy its followers by continuing to attack capital and enterprise by word and deed. Every now and then some measure was passed, or some statement made, which antagonised the owners of capital. Worse still, there was an utter lack of discipline and respect for private property in France. The Government was simply unable to control its own followers. Apart altogether from the sporadic outbreaks which followed the epidemic of stay-in strikes of June 1936, there were innumerable minor manifestations of the disquieting spirit which appeared to have seized the French working classes.

In such circumstances it was no wonder that wealthy people considered it safer to retain their capital abroad, and even to continue to transfer the funds for which they had no immediate use at home. While originally most of the capital left France in anticipation of a devaluation of the franc, subsequently the character of the bulk of French refugee funds underwent a change. To some extent their owners were still afraid of a further depreciation, but to a much larger extent they were afraid of anti-capitalist legislation by the Government, of irresponsible anti-capitalist acts by the working classes, and even of a revolution. This being so, it would have been difficult for MM. Blum and Auriol to secure success for the devaluation, even if they had carried it out in the best possible way. This was, however, no reason for them to carry it out in the worst possible way.

(5) The Rich Men's Revolt

After a brief period of respite following upon the devaluation, the flight of capital was resumed in full force. To an increasing degree this flight assumed a political character. It constituted a measure of retaliation by the wealthy classes against an anti-capitalist Government. It was, in fact, the first of the series of "Rich Men's Revolts" to be witnessed within the next year or so. I do not mean to suggest that there was a plot between the large number of wealthy people in France to sabotage the monetary management of the country by exporting their capital abroad. This consideration may not consciously have played an important part in influencing the decision of individual owners of capital. While the main reason for exporting their capital was to safeguard it against anti-capitalist measures, it must have caused some satisfaction to them to know that, in transferring their funds abroad, they could do

their bit to embarrass the much-hated Front Populaire. It probably did not occur to them that when aiming at MM. Blum and Vincent Auriol, they were hitting France, but then considerations of party overshadowed national considerations also in the Government's various acts, so that there was really very little to choose between the two sides from that point of view. As somebody once rightly remarked: "There is no nation in France, there are only parties." Nor is France unique in this respect.

Towards the end of 1936 the Government realised that it was helpless against the resistance, partly passive and partly active, of the wealthy classes. The measures compelling the surrender of gold holdings at the pre-devaluation price of the metal were impossible to enforce to any degree. Even though the banks were under legal obligation to supply the Government with information about their clients' foreign transfers, they refused to do so, and the Government was unable to apply the letter of the law without giving rise to a wholesale withdrawal of deposits as a result of the publicity which would be given to any measures taken against the banks.

Instead of making a concession by paying the full price for gold as was done in other countries, the Government retreated from its mistaken position at the rate of one inch at a time. In December 1936 it issued a gold franc loan. For each hundred gold francs subscribed, 140 paper francs were to be repaid in three years' time. The actuarial value of these 140 paper francs was, however, some 7 or 8 per cent short of the actual market value of the gold francs. It was a niggardly, pettifogging offer, and it was no wonder that the response was so unsatisfactory. In any case, most holders of gold were unwilling to acquire Government loans.

(6) The London Credit

By January, not only had the Exchange Stabilisation Fund lost all the gold obtained as a result of repatriations immediately after the devaluation, but it had also virtually exhausted the gold stock allocated to it from the gold reserve of the Bank of France. The choice was between admitting the failure of the devaluation by devaluing the franc further, and continuing to bolster up the franc by drawing upon the Bank of France's gold reserve. The publication of a decline in the Central Bank's gold stock would have led, however, to an accentuation of the flight from the franc, and the Government was anxious to avoid this. To that end it concluded a credit of £40 million

with a group of London banks. It was the second credit of this kind. The first was concluded by the Government of M. Sarraut in February 1936, and was repaid on maturity in November and December 1936. Although officially it was an unsecured credit, in reality the Bank of France gave the Bank of England an undertaking to earmark as specific security for the duration of the credit, gold or sterling equivalent to the outstanding portion of the credit.

On the present occasion the London banks were even more exacting. They insisted upon full legal security, which was, however, impossible without indicating in the Bank of France's returns that part of the gold stock was legally pledged. Eventually a solution was arrived at by which the gold equivalent of the £40 million was to be kept this time not in Paris but in London, and the Bank of France undertook to abstain from withdrawing this gold so long as the credit was not repaid. Thus the legal position was that, while in case of a default the London banks would have been unable to satisfy their claims by seizing the gold deposit, the French authorities would have derived no benefit from the default, since they would have been unable to withdraw the gold. This was calculated to satisfy even the most exacting of London banks. Nevertheless the credit met with strong opposition from some of them. It was an open secret that the amount, which was originally fixed at £50 million, had to be reduced at the eleventh hour to £40 million owing to the decision of Lloyds Bank and the National Provincial Bank to refrain from participating. Their unwillingness was not due in any way to dissatisfaction with the terms offered but to a desire not to antagonise their wealthy French clients, who viewed the credit transactions with strong disapproval owing to their hostility towards the Front Populaire Government. Accordingly these two banks withdrew from the syndicate and the amount was reduced to £42½ million. Since it was impossible to fix the credit at such an odd figure, it had to be scaled down to £40 million.

(7) Budgetary Difficulties

The granting of the credit reversed for the moment the adverse trend of the franc, but before long the more hopeful feeling created by this transaction spent its force and the flight from the franc was resumed. By the end of February most of the proceeds of the credit had been in the defence of the franc.

Internal budgetary conditions were also going from bad to worse. In other countries which devalued their currencies,

the revival of trade that followed the change, coupled with the rising trend of commodity prices, resulted in an increase of revenue enabling the Government to balance the budget. In France the deficit was much too large to be met through a devaluation by a mere 30 per cent. Moreover, the devaluation was not followed by any noteworthy revival of trade. Although commodity prices were rising, the effect of their rise upon taxation revenue did not go far towards meeting the increase in expenditure. M. Auriol disclosed, in the course of the budget debate in December 1936, that no less than 42 per cent of the total expenditure went towards the service of the public debt. It was impossible to meet this deficit by means of normal borrowing, and the Treasury had to resort to drawing upon the Bank of France. Two months after the repayment of part of the Government's advances from the Central Bank out of the big profit derived from the revaluation of the latter's gold reserve, inflationary borrowing was resumed. Week after week the so-called "provisional" loans of the Bank of France to the Government—the use of the term amply confirms the popular French saying, "*Ce n'est que le temporaire qui dure*"—increased, and early in 1937 it looked as though before very long the Government would exhaust the borrowing power fixed by the law of June 1936.

(8) The 40-Hour Week and the Trade Balance

At the same time the position of the franc became increasingly undermined also as a result of the further deterioration of the trade balance. The devaluation of the franc should, in the ordinary course, have reduced the deficit of visible trade and increased invisible exports represented by tourist spendings. Amidst the conditions prevailing in France, it produced neither of these beneficial effects. The adverse effect of the gradual application of the 40-hour week, and still more of the lack of industrial discipline upon the volume of production, resulted in a marked deterioration of the trade balance. French exporters were unable to take full advantage of the improvement of their chances to compete abroad as a result of the depreciation of the franc. Imports increased, partly as a result of rearmament requirements, partly through the decline of home production, and partly through the reduction of customs duties and increase of quotas introduced after the devaluation of the franc in a futile attempt to counteract the rising tendency of the cost of living. The visible adverse balance showed month after month a remarkable increase

compared with the pre-devaluation period. Nor was the tourist season so satisfactory as might reasonably have been expected after the depreciation of the franc. Many people kept away from France for fear of violent political disturbances. Others cut their stay short because of unpleasant experiences arising from the truculent attitude of porters, taxi-drivers and others towards wealthy tourists. Thus in addition to the flight from the franc, the French authorities also had to bear the brunt of a growing deficit in the balance of payments.

(9) M. Auriol's Mistakes

Throughout that period the policy and tactics pursued by the French Government in monetary matters were an orgy of incompetence. In fact, the way in which M. Vincent Auriol managed to be consistently wrong compelled a kind of reluctant admiration. It cannot be easy to be invariably wrong. It is probably almost as difficult as to be invariably right. The law of averages makes it probable that everybody will occasionally be right, if only by accident. M. Vincent Auriol seemed to be an exception to this rule. Even on the rare occasions when he did the right thing he did it in the wrong way.

By the beginning of March, both M. Blum and M. Auriol realised that this state of affairs could not continue. The necessity for coming to some sort of compromise with their opponents became painfully evident. Accordingly they made some important concessions, as a result of which a truce came about between the anti-capitalist Government and its capitalist opponents.

CHAPTER X

THE TRUCE OF MARCH

(1) M. Blum's Concessions

March 8, 1937, constituted a turning-point in the history of the Front Populaire Government. It marked the beginning of a reversal of the anti-capitalist trend. Apart from temporary setbacks, this changed trend has continued to prevail up to the time of writing. It became accentuated with the change of Government in June 1937, when MM. Blum and Vincent Auriol relinquished their office in favour of MM. Chautemps and Bonnet. They had actually relinquished a substantial part of their power in March, when the Government appointed a committee of " neutral " experts to be in charge of the control of the Exchange Stabilisation Fund and of the market in Government loans. This committee of experts consisted of M. Labeyrie, Governor of the Bank of France, who in every respect was M. Blum's nominee ; M. Jacques Rueff, a senior official of the Treasury who, though a Government official, held largely independent views ; and MM. Rist and Baudouin, who were clearly the nominees of the " 200 families ". Thus High Finance, whose power had been eclipsed when M. Blum assumed office, was once more in a position to make itself felt in the management of French monetary policy.

At the same time M. Blum had to make other concessions. The penalising measures against holders of gold were waived, and the Bank of France was prepared henceforth to pay the equivalent of the world market price for the metal. M. Blum made a statement promising to cut down expenditure, and adopted altogether a conciliatory attitude towards capital and enterprise. He announced the issue of a loan with guaranteed exchange and option of payment in foreign currencies. The rigid defence of the franc around 105 was also relaxed.

The immediate result of these measures was a wave of repatriation and dishoarding. The first tranche of the new loan was a success and this induced the Government to issue the second tranche immediately, before the market was ready to absorb it. Consequently, the price of the new loan went

to a discount, and this somewhat damped the favourable impression created by the change in the Government's attitude. Nevertheless, for the next two months or so the Treasury's deficit was covered by 8 milliard francs obtained from the first two tranches of the loan, and the Government was in a position to breathe more freely.

(2) Re-enter the "200 Families"

One would have expected that the restoration of the influence of the "200 families" over monetary management would strengthen the orthodox spirit of the French monetary policy. After all, in the past, until the advent of the Socialist Government it had been the "200 families" who had blocked the way to the devaluation of the franc. It had been their influence which defeated M. Flandin. M. Laval was the executing hand of the "200 families" when he enforced his brutal deflationary decrees. With the advent of the Socialist Government, however, the "200 families" changed front altogether. From the moment when M. Blum assumed office they urged the devaluation of the franc. After the devaluation, their appetite for devaluations grew considerably. After all, they did not do so badly out of the first devaluation, even though M. Vincent Auriol's measures for some time prevented them from taking their profit by selling their gold at its new franc value. The very same people who a year earlier had insisted upon the defence of the franc at 75 to the pound irrespective of the sacrifices involved now insisted upon the abandonment of the defence of the franc at 105. They were not even satisfied with demanding a depreciation to the legal minimum limit of 43 milligrammes of gold of ·900 fineness per franc, which at the time was equivalent to about 112 francs to the pound. The demand that the legal limit should be waived was becoming increasingly loud.

Undoubtedly the "200 families" were as right this time as they had been wrong a year before. That a further substantial depreciation of the franc was necessary and inevitable was becoming increasingly obvious. The equilibrium established provisionally by the devaluation of the franc to the extent of 30 per cent had ceased to exist as a result of the increase in the French cost of production through the application of the 40-hour week and through the all-round rise in the French price level. Even though world prices were also rising fast, the rise in the price of goods produced in France was much more substantial than the rise in the cost of imported goods

which were directly affected by the devaluation and by the rise in world prices.

(3) Further Devaluation Inevitable

What was even more important, there was not the slightest hope of balancing the budget unless the franc was devalued further. The rise in prices, substantial as it was, was not sufficient to bring about an adequate increase in revenue. The French Government was confronted with a very awkward dilemma. From a budgetary point of view a further rise in prices was necessary and desirable. The advantage gained by it would, however, have been outweighed by the growth of the international overvaluation of the franc and by the social repercussions of the increase in the cost of living. This latter consideration induced the Government to resist as far as possible the rise in prices. The rise continued, however, notwithstanding the resistance. Between October 1936 and March 1937 wholesale prices advanced by more than 17 per cent. In order to obtain a really substantial increase in revenue, a much more pronounced rise would, however, have been necessary. In the absence of such a rise, the budgetary problem was simply impossible to solve and the staggering deficits could not be covered otherwise than by inflationary borrowing. This being so, the resistance to a depreciation of the franc was as hopeless at 105 as it had been at 75.

The " 200 families " duly realised this. It is indeed remarkable how their judgment improved from the moment when they ceased to control the monetary policy of their country. Had they been blessed with the same degree of realism two years earlier, France would never have been driven into the arms of Socialists and Communists by a ruthless deflationary policy.

(4) Temporary Respite for the Franc

Realising the necessity for a further devaluation, MM. Rist and Baudouin insisted upon it from the very beginning. It was impossible, however, for them to have their way to any substantial degree. At the outset they were even unable to persuade the Government to allow the franc to depreciate to its lower legal limit. On March 8 the franc was allowed to depreciate to about 108 to the pound, following upon the declaration of a change of policy, but when this depreciation resulted in a buying pressure the exchange was allowed to recover to 106½. This was the first of a series of identical

technical errors committed by the French monetary authorities in the course of the next few months. Every time the franc depreciated, there was a chance to replenish their foreign exchange reserves by preventing the subsequent recovery. In every instance, however, the French authorities were unable to resist the temptation to allow the franc to recover. As a result, they were unable to acquire a sufficient amount of foreign exchange to face the next attack on the franc. Time after time the disadvantages of this attitude became obvious, yet on the next occasion the French authorities pursued the same course.

At the beginning there was very little apparent change in the management of the exchange. The franc seems to have been pegged around 106½ and the authorities had no difficulty in maintaining it at that level. Although the volume of repatriation and dishoarding was relatively moderate, it enabled the French Exchange Stabilisation Fund to replenish its stock of foreign exchange to some extent. This favourable tendency would not have lasted many weeks but for the intervention of the gold scare. We saw in Chapter V how the temporary recovery of the franc was one of the minor causes leading to the gold scare. At the same time the gold scare resulted in the prolongation of the favourable spell in francs. As is very often the case, one man's poison proved to be another man's meat.

(5) Effect of the Gold Scare

We described in Chapter V the technical situation as a result of which the volume of gold offered in the London market was in excess of the facilities for shipment to New York. Since some of the owners were in a hurry to liquidate their stocks, they were prepared to sell the gold to the Bank of France at the latter's official buying price, even though that price was slightly below the London parity. The influx of gold thus obtained was considerably in excess of the amount of French funds repatriated. It was therefore inevitable that the purchases of gold by the Bank of France should lead to a selling pressure on the franc. Under the policy of pegging, this again would have led to sales of foreign exchange by the Exchange Stabilisation Fund, so that a large part of the influx of gold would have been lost. For once, however, the French authorities did the right thing. While they bought up all the gold offered to them for sale, they did not support the franc against the adverse effect of these purchases. The franc was allowed

to depreciate to about 110, which was in the vicinity of the lower legal limit. Since the desirability of allowing the franc to depreciate at least to its legal limit was obvious, the choice of the moment for making the change was very well-advised indeed. It was evident that the depreciation of the franc was this time not a sign of weakness. It was not due to any new flight from the franc but to an influx of gold, which strengthened the technical position. In other words, the depreciation of the franc constituted a strategic retreat and not a flight after a lost battle.

From a psychological point of view, too, the gold scare was beneficial to France. By April the spirit of the truce between the anti-capitalists and the capitalists had begun to wear thin. The hatchet was not buried deep enough. Beneath the smooth surface, hostile feelings were at work. The Left Wing supporters of M. Blum strongly resented what they regarded as the capitulation of the Front Populaire to its opponents. They were doing their best to upset the truce. Nor were the "200 families" satisfied. Having tasted blood, they thirsted for more.

(6) French Dishoarding and Repatriations

By the end of April the proceeds of the first two tranches of the new loan with guaranteed exchange had been spent. The issue of a third tranche was impossible, owing to the fact that the first two tranches had depreciated to a fairly heavy discount; this in spite of the fact that the depreciation of the franc that had taken place in the meantime increased the franc value of the exchange option. Although M. Vincent Auriol made a feeble effort to reduce, or at any rate keep down, the budgetary expenditure, the deficit remained a problem impossible of solution. The possibility of resuming borrowing from the Bank of France had to be envisaged.

Notwithstanding this, the anticipation of another major crisis for May did not materialise. Its absence was due to the prolonged gold scare, and to the slumps in foreign markets that accompanied it. The immediate effect of the gold scare was heavy selling of gold-mining shares by French holders in the Paris bourse, and since the counterpart of these sales was found for the most part in London, the result was a certain amount of repatriation. Moreover, fears of a cut in the price of gold, and the uncertainty created by these fears, deterred many Frenchmen from sending their capital abroad. The majority of French hoarders of gold liquidated their holdings and even

though most of them kept the proceeds in either dollars or sterling, some of them, at any rate, repatriated their capital.

The respite provided for France during April and May was certainly on the credit side of the balance sheet of the gold scare. It did not, however, confer any lasting benefit on France. The franc was so definitely fated to a further substantial depreciation that any such respite could only be temporary and could only postpone the inevitable fall. It is interesting to speculate on what would have happened to the franc in the absence of the gold scare. Presumably the sweeping adverse pressure which was responsible for its eventual depreciation at the end of June would have taken place some time during April or May. It is conceivable that instead of resigning, the Blum Government would have taken up the challenge and resorted to drastic anti-capitalist measures, especially exchange restrictions. M. Labeyrie is known to have been urging M. Vincent Auriol ever since 1936 to adopt exchange restrictions, but the Government was unwilling to follow his advice. Conceivably it might have been induced to do so during April or May as a result of a revival of the " Rich Men's Revolt ". Even in that case, the chances are that the franc could not have been defended indefinitely with the aid of exchange restrictions, and would eventually have had to be allowed to find its level.

CHAPTER XI

EXIT M. VINCENT AURIOL

(1) End of Respite for Franc

The lull in the pressure on the franc was too good to last. It came to an end in June, as a result of Treasury difficulties leading to the development of a sweeping wave of distrust. To some extent the fact that after its climax at the beginning of June the gold scare had materially subsided by the middle of that month also contributed to the new franc crisis, since gold had ceased to monopolise the attention of the world's financial markets.

In the course of May the Treasury spent the remains of the proceeds of the 3½ per cent loan with guaranteed exchange. The months of May and June are always unfavourable for the French Treasury, since there is a seasonal fall in receipts. In both 1935 and 1936 it was during that period that the smouldering crises of the franc came to a head, and for this reason alone another panic was generally anticipated. When it became evident that the Treasury would have to borrow once more from the Bank of France, and that the latter's gold reserve was being drawn upon in order to meet the pressure on the franc, the flight of capital and speculative selling once more assumed sweeping dimensions.

(2) Paris Exhibition Fiasco

The Government entertained sanguine hopes that the success of the Paris Exhibition would turn the tide in favour of the franc. Elaborate preparations were made to make the Exhibition an outstanding affair. It was declared to be the symbol of the new régime in France. As a matter of fact it did become the symbol of the new régime, though not in the sense in which M. Blum had expected. It came to symbolise the utter inefficiency of French Socialism. The opening of the Exhibition was fixed for the middle of May. By that time, however, only two pavilions were ready—the German and the Italian, which had been built and equipped by workmen imported from Germany and Italy. The remaining pavilions,

which were constructed mainly by French workmen, were not finished for months after the official date of opening. In vain did M. Blum appeal to the workmen engaged in building the Exhibition, calling them "the shock troops of the Front Populaire" and emphasising the importance of the success of the Exhibition from the point of view of the Front Populaire Government. There were interminable delays, and strike followed strike. Although the Government spent money lavishly, it was unable to speed up the work, and by the middle of June only a very small part of the Exhibition was presentable. Thus hopes that the visitors to the Coronation in London would proceed to Paris to inspect the International Exhibition were largely disappointed. The extent to which the Exhibition yielded foreign exchange during M. Blum's term of office was negligible. By the irony of fate, in subsequent months, when the Exhibition was at last really ready to receive visitors, it became a very important factor in bringing in foreign exchange and in improving trade in France. The experience of the Paris Exhibition showed the fatal weakness of the Socialist Government, namely that it was entirely incapable of enforcing discipline among its followers.

(3) MM. Rist and Baudouin Resign

The crisis became accentuated when the news was broken that two members of the committee in charge of the management of the franc, MM. Rist and Baudouin, had resigned their posts. Their letter of resignation somehow managed to find its way into the Press, and the facts disclosed therein were eminently likely to cause panic. MM. Rist and Baudouin stated in that letter that the resources of the Exchange Stabilisation Fund had been virtually exhausted. They also disclosed the fact that they were in favour of a greater "elasticity" of the franc. This introduced a new expression, which was to play a prominent part in French monetary developments during the next few months. In 1936, when it became evident that devaluation was inevitable, the French authorities sought to soften the blow by referring to the operation as the "alignment" of currencies. Now that a further depreciation of the franc had become inevitable, it was referred to as the restoration of the "elasticity" of the franc.

MM. Rist and Baudouin were unquestionably right. By June the application of the 40-hour week was producing its effect on the price level and the cost of production, and the growing trade deficit was also weighing heavily on the franc.

The utter futility of supporting the exchange at the level to which it had been devalued a year before was becoming increasingly evident.

MM. Blum and Vincent Auriol refused, however, to face this fact, just as they had refused to face the necessity of a devaluation a year earlier. They felt that their personal prestige was at stake. The abandonment of the Auriol franc would have amounted to an admission that the devaluation of 1936 had been a failure. Nor would it have been easy to pass through Parliament another devaluation law. It would have placed the Front Populaire under a very severe test. Nevertheless, this was no excuse for postponing the inevitable. The experience of 1936 proved that while Parliament may be reluctant to give preliminary consent to devaluation, it is quite willing to put up with a *fait accompli* the responsibility for which rests with the Government.

(4) Pressure in Favour of Exchange Restrictions

In the course of June it became obvious that something had to be done, but nobody knew quite what, least of all the Government. M. Blum and his Finance Minister hesitated between pressure brought to bear on them by experts and Treasury officials in favour of the restoration of the elasticity of the franc, and the growing demand for exchange restrictions coming from the Left Wing of the party and strongly supported by M. Labeyrie. Hitherto the Government had refused to envisage the possibility of the adoption of exchange restrictions, for the simple reason that such a step was pronounced by its own supporters to amount to Fascism. The conception that exchange restrictions form an integral part of the totalitarian system has taken deep root in France and other democratic countries, and even the strongest arguments in favour of such measures were simply ruled out of court on that account. Thus although the measure would have been directed primarily against the wealthy classes, the Socialist Government hesitated to adopt it, simply because similar measures had been taken by Fascist States and therefore could not be right. In any case, however, the adoption of exchange restrictions at that stage would not have provided the solution for France. The franc was not low enough, and it would have depreciated in spite of exchange restrictions, which could hardly have been made watertight in the course of a few months. Nevertheless, by the middle of June the French Government was inclined to waive its aversion to exchange restrictions and was quite

prepared to adopt them in an attempt to avoid the depreciation of the franc.

(5) Negative Attitude of Partners in Tripartite Agreement

One of the reasons why the Government was so firmly determined to prevent a depreciation of the franc was the desire to remain within the Tripartite Agreement. It was in this respect that London and, to a less extent, Washington, assumed responsibility for the prolonged defence of the franc at an untenable level. Throughout that period the British and United States authorities showed very little understanding of the difficulties of France. They insisted upon the letter of the Tripartite Agreement, and were most reluctant to agree to a depreciation of the franc. When in September 1936 the French Government informed London and Washington of its intention of devaluing the franc by 30 per cent with the option of varying this percentage between 25 per cent and 35 per cent, the extent of the devaluation was objected to as being excessive. It was only with difficulty that the British and United States Treasuries were persuaded to agree to a devaluation by 30 per cent. The developments of the next few months proved how faulty their judgment had been, since, far from being excessive, the devaluation of September 1936 was not nearly sufficient. Nevertheless, London and Washington continued to block the way even to the adjustment of the franc to its lower legal limit, which was eventually agreed to with the utmost reluctance. Again, in June 1937, London and Washington were strongly against a depreciation of the franc below its legal minimum limit.

This attitude was due to the mentality that had developed in official quarters and among substantial sections of the public after 1931. Owing to the fact that countries with undervalued exchanges were prosperous, while countries with overvalued exchanges had to put up with deflation and depression, a pathological fear had developed that, through excessive devaluation by some other country, their exchanges might become overvalued. The Washington Administration was determined never to allow sterling to depreciate below its old parity of 4·86 against the dollar. It was not concerned to anything like the same extent with a depreciation of the franc. Since, however, the British Treasury feared that such a depreciation might necessitate a depreciation of sterling, the Washington authorities supported its opposition to a depreciation of the franc.

In reality the arguments which had been valid in the past against the undervaluation of an exchange no longer held good to the same extent regarding the franc. For one thing, the proposed depreciation of the franc did not primarily serve the purpose of competition in the sphere of international trade, competition against which the Tripartite Agreement was primarily directed. It had been made necessary by the internal disequilibrium in France, which called for adjustment in order to enable the Treasury to meet its requirements. Nor did it appear probable that a further depreciation of the franc would give French trade an undue advantage against British and American competition, for costs and prices were rising fast in France and there seemed to be every reason to assume that they would soon become adjusted to the lower international value of the franc.

Notwithstanding this, France's partners in the Tripartite Agreement objected to a further depreciation of the franc, and M. Blum was extremely reluctant to risk an open breakdown of that Agreement, which had come to be regarded as a kind of alliance between the democratic countries. On the other hand, France's partners in the Tripartite Agreement were equally determined to uphold the principle of the freedom of exchanges, which was one of the fundamental conditions of the Agreement. Thus London, and Washington, objected to a depreciation of the franc, and also to the application of the only practicable method by which that depreciation might have been delayed to some extent. This purely negative attitude did not make things any easier for the French Government.

(6) The Government asks for Exceptional Powers

It was in such circumstances that the Government submitted to Parliament a bill giving it full powers to deal with the financial problem. It was an open secret that the main object of the move was to secure a free hand for the adoption of exchange restrictions. By that time the Government had realised that the truce with the capitalists would not work, and it was being pressed by its Left Wing supporters to revert to the policy of the big stick. Exchange control was to be part of its new policy, which would also have included a stricter supervision of banking activities. It was believed that the exceptional powers to be obtained from Parliament would be used for the establishment of an organisation for that purpose, under the leadership of M. Horace Finaly, the late Managing

Director of the Banque de Paris et des Pays Bas. After some difficulty, the bill conferring exceptional powers upon the Government for the solution of the financial problem was passed by the Chamber on June 16, though not without certain limitations on the use of that power. Its reception by the Senate was, however, decidedly hostile. The composition of the Senate was much less Radical than that of the Chamber of Deputies, and it was only with the utmost reluctance that during 1936 the Upper Chamber had passed the various social reform measures which had been passed by the Lower Chamber. A large and increasing section of the Senate viewed with serious disapproval the Government's policy, which was leading to a deterioration of the financial conditions. At the same time, however, the Senate was extremely reluctant to oppose a Government which evidently continued to enjoy the support of the majority of the electorate.

(7) M. Caillaux Hits Back

It was at this stage that M. Caillaux took a hand. The situation provided him with a supreme opportunity to get even with the opponents who had defeated him in 1935. That bitter experience, when the Bouisson Government, with M. Caillaux as Finance Minister, was defeated after having been in office for two days, is described in detail in *World Finance 1935–1937*. M. Caillaux's defeat by two votes was attributed in part to the uncompromising hostility of the parties of the Left, who regarded him as a renegade turned reactionary, after his Radical past. To a very large degree, however, his defeat was attributed to lobbying by financial interests, especially M. Finaly. The latter had been thought largely responsible for M. Caillaux's failure in 1926, and he had every reason to fear that M. Caillaux, on his return to office, would remember the past. In fact, in *World Finance, 1935–1937*, I described how on the morning of the fateful debate in the Chamber on June 4, 1935, he said to a visitor: "*Ce soir, la vote de confiance. Demain matin, les decrets. Et demain soir, la perquisition chez Finaly.*" A financier of M. Finaly's skill and influence could not have found it difficult to persuade a few deputies to vote against the Bouisson-Caillaux Government, which was thus defeated.

The situation of June 1937 offered M. Caillaux an opportunity to square accounts with both his Socialist opponents and M. Finaly personally. The latter had become *persona grata* with the Blum Government. In fact, as I have pointed

out, it was said to be M. Blum's intention to put M. Finaly in charge of an inspectorate of banking with extensive powers. M. Caillaux was determined to stop this at all costs, and he had the full support of banking interests.

(8) Exit M. Finaly

He delivered his first blow against M. Finaly. For years there had been a hard struggle between the latter and M. Moreau, Chairman of the Banque de Paris et des Pays Bas, of which M. Finaly was Managing Director. M. Moreau was M. Caillaux's man, and from the time when he joined the Banque de Paris et des Pays Bas, after resigning from the Governorship of the Bank of France, it had been evident that the two heads of the bank would not to able to work together in harmony. Their hostility to each other was an open secret. In one instance, a conference was held at the Banque de l'Indo-Chine to discuss an important transaction in which the Banque de Paris et des Pays Bas was closely concerned. Both M. Finaly and M. Moreau turned up at the conference. In the course of the discussion a letter from the Banque de Paris et des Pays Bas, bearing M. Finaly's signature, was produced. M. Moreau, having glanced at the letter, said: "This is not valid. I did not sign it."

Such incidents occurred from time to time, and it is easy to imagine what the relations of the two men must have been on the Board. Each had his supporters among the directors, and whenever there was a vacancy, each did his utmost to secure the seat for his nominee. It was, in fact, disagreement over the appointment of a director that led to M. Finaly's eventual defeat. Early in June the Board of the Banque de Paris et des Pays Bas had to decide about the appointment of a director. M. Finaly was anxious that M. Athalin, who had just retired from the Managership of the Bank, should be given the seat on the Board. M. Moreau was determined to prevent this, in order that M. Finaly's influence on the Board should not increase. Since M. Athalin was popular with the directors, M. Moreau opposed his nomination on considerations of principle, insisting that vacancies should be filled by financiers from outside the Bank, who had good connections and could bring new business to it. The principle was put to the vote, and M. Finaly was defeated. He thereupon resigned, and after his departure from the meeting, M. Athalin was unanimously elected a director. Although the blow was struck by M. Moreau, the directing hand was that of M. Caillaux. It was

presumably after this defeat that M. Finaly definitely threw in his lot with the Front Populaire Government. In any case, his friendly relations with M. Blum had made him unpopular with the " 200 families ".

(9) M. Blum Defeated

His plans, and those of the Socialist Government, were, however, frustrated by M. Caillaux. For an old Parliamentarian of his skill it was not difficult to rally all the discontented elements in the Senate and induce them to make a stand. The septuagenarian politician proved that, even though he was no longer capable of forming a Government, he was quite capable of smashing one. As a result of M. Caillaux's efforts, the bill conferring exceptional financial powers upon the Government was defeated by the Senate on June 21, 1937, and the Blum Government resigned. M. Caillaux had succeeded in settling his account for June 1935.

Throughout the second half of June, while M. Blum's bill was being debated by Parliament, the flight from the franc assumed sweeping dimensions. This was due to fears that the exceptional powers would be used for a depreciation of the franc, exchange restrictions, an increase of taxation, or even the nationalisation of railways and other enterprises. The extent of the flight may be judged by the fact that during June the gold reserve of the Bank of France declined from 57,358 million francs to 48,859 million francs. At the same time the percentage of gold cover declined to 47½ per cent and was getting dangerously near the legal minimum of 40 per cent. It was amidst such conditions that the Government of M. Chautemps was formed.

On the surface it may seem surprising that M. Blum gave in so easily after his defeat by the Senate. He was fully expected by a large number of both his supporters and his opponents to rely upon his majority in the Chamber and override the opposition of the Upper House. Had he wished to remain in office, he could certainly have done so without difficulty. Nevertheless, after twelve months' experience he had begun to realise what he was up against. He became aware of the importance of the financial problem and realised that his Government was incapable of solving it. His original policy of proceeding with social reform irrespective of its financial consequences had brought France to the verge of bankruptcy. He could not afford to reverse that policy, and yet its reversal had become necessary in order to set the

country's finances in tolerable order. In order to improve the budgetary situation it became necessary to stem the tide of expenditure which his Government had indulged in. It also became necessary to abstain from going any further with social reform, and even to mitigate the application of some of the measures which had already been passed. The alternative was a complete collapse of the franc, with all its consequences. M. Blum doubtless realised that he could ill afford to antagonise his own party by taking the unpopular steps necessary for financial reconstruction. He therefore decided to let someone else take them. He was fully aware that with the large majority of the Chamber behind him he continued to control the situation, even though he might disclaim direct responsibility by relinquishing the Premiership. What he probably intended to do was to allow M. Chautemps to tidy up the mess, and then return to continue his experiment of social reform. There can be no doubt that his decision to give way after having been defeated by the Senate was the consequence of the depreciation of the franc. Like all the French Governments from 1935 onwards, he was defeated by the franc.

CHAPTER XII

ENTER M. BONNET

(1) Efflux of Gold

The French public was greatly relieved when the Cabinet crisis caused by M. Blum's defeat by the Senate came to a speedy conclusion with the formation of the Chautemps Cabinet. It was feared that in the case of a prolonged Cabinet crisis, France might witness violent street disturbances. In the circumstances the advent of a moderate Government was considered to be a change for the better, even though its existence was dependent upon the support of the Socialists who retained a number of portfolios in the new Cabinet.

The allocation of the financial portfolio to M. Georges Bonnet gave rise to speculation as to the monetary policy which the new Government was likely to follow. M. Bonnet had been known in the past as a man who held strong orthodox views. In fact, during the London Economic Conference of 1933 he was largely responsible for the formation of the Gold Bloc. On this ground it was believed that he might be reluctant to agree to a further devaluation of the franc. On the other hand, he was known to be strongly opposed to any form of exchange restrictions. It was very difficult to foresee which of the two measures he would adopt. At the time of the formation of the new Government, M. Bonnet was French Ambassador in Washington, and pending his return nothing was decided about the course of monetary policy. The authorities continued to defend the franc, even though this was becoming increasingly costly. While M. Bonnet was hurrying back across the Atlantic to take up his post, his ship passed several mail-steamers loaded with French gold being taken to his former country of residence. M. Bonnet is known to have come back from Washington with a piece of good advice from President Roosevelt. "Whatever you do," the President is reported to have said, "balance your budget." This good advice, coming as it did from one who created a peace-time record in the unbalancing of budgets, appeared to be of very little help.

(2) The Franc allowed to Depreciate

On his arrival, M. Bonnet soon showed his hand. Acting upon the advice of the two former members of the expert committee in charge of the management of the franc, he promptly restored the " elasticity " of the currency. In other words, he removed the peg and allowed the franc to find its level. Thereupon the franc depreciated to 130 to the pound, against 112. This fall was followed by a partial recovery, and once more the French authorities were unable to resist the temptation to allow the recovery to take its course, instead of taking advantage of it to replenish their sadly depleted foreign exchange reserves.

M. Chautemps found no difficulty in obtaining from both Houses of Parliament the full powers which the Senate had refused to grant to M. Blum. The Government thereupon passed a series of important measures. The gold reserve of the Bank of France was revalued, still on the basis of the monetary law of October 1936, from the legal maximum of 49 milligrammes of gold of ·900 fineness per franc to 43 milligrammes. The result was the increase of the gold reserve during the last week of July from 48,859 million francs to 55,677 million francs. The profit on this revaluation was placed at the disposal of a new fund called *Fond du soutien de marché des rentes*, established for the purpose of supporting the market in Government securities. As we shall see later, this institution has proved to be one of the outstanding mistakes of the new Government. At the same time, arrangements were made to increase the Treasury's borrowing power from the Bank of France, and a new advance to the maximum of 15 milliard francs was agreed upon, in addition to the outstanding amount of some 24 milliard francs by the end of July.

Above all, stress was laid upon the Government's determination to improve the budgetary situation. In the course of the subsequent weeks, M. Bonnet actually introduced a series of drastic measures leading to substantial cuts in expenditure and an increase in revenue. The Government also endeavoured to restore cheap money. During the crisis of June, the Bank of France raised its rediscount rate to 6 per cent, showing that notwithstanding the change of régime it was guided by the principles of monetary orthodoxy discredited and discarded in most other countries. Since the 6 per cent bank rate could not check the flight from the franc,

the new Government decided to reduce it and allow the franc to depreciate rather than indulge in futile attempts to check this trend by maintaining an unduly high bank rate. By September the bank rate was down to 3½ per cent, even though in the meantime the franc had been subject to several attacks.

(3) Fiscal Measures fail to restore Confidence

Notwithstanding the evidence of efforts to balance the budget, the wave of distrust towards the franc failed to subside. Although M. Bonnet's measures appeared to have reduced the deficit by 23 milliard francs, there remained some 24 milliards to be found by means of borrowing. This fact gave rise to fears that the Government would have to fall back upon the Bank of France to a large and increasing degree, and that inflation would thus continue even under the new régime. Above all, the French public was by no means certain that the new Government would remain in office after the reassembly of Parliament. Some of the economy measures were openly denounced by a number of Left Wing Government supporters, and it was feared that in November the measures would not be ratified by the Chamber. And since the alternative to M. Chautemps' Government was the return of M. Blum, the prospects were viewed with growing pessimism.

In fact, the outlook for the franc was judged according to whether the chances of the survival of the Government were considered favourable or not. From this point of view, much importance was attached to the impending change in the management of the Bank of France. It was evident that M. Labeyrie could not survive the departure of the Blum Government. His appointment had been purely political and he was entirely M. Blum's personal nominee. It was widely believed that his place would be taken by M. Baudouin. It stands to reason that the latter, who held a good position as the head of the Banque de l'Indo-Chine, would not sacrifice it for the sake of the Governorship of the Bank of France unless he considered it extremely probable that the Chautemps Government would remain in office for some time. And since French financial quarters had a very high opinion of M. Baudouin's judgment, his appointment as Governor of the Bank of France would have been generally regarded as an indication that M. Chautemps was likely to remain in office for a long time. When eventually it was announced that M. Labeyrie's post had been given to M. Fournier, the Deputy-Governor and a former Treasury official, the announce-

ment was received with mixed feelings. Although the essentially non-political character of this appointment was received favourably, the fact that M. Baudouin had not, after all, accepted the Governorship was considered a bear point for the Chautemps Government and for the franc.

(4) Signs of Improvement

Yet there was no lack of signs of improvement. The Paris Exhibition was at last really complete and attracted a large number of tourists. Hotels in Paris were full to overflowing and, owing to the cheapness of the franc, the various French holiday resorts were also overcrowded. Foreign exchange was coming in, and during the months of the Exhibition the invisible export of tourist spendings probably more or less offset the deficit in the visible trade balance. At 128 to the pound the franc was somewhat nearer to its equilibrium level than it had been at 112. The budgetary outlook appeared to be rather better, even though most people preferred to reserve judgment in this respect. In the past, fiscal efforts which looked very impressive on paper had often produced insignificant results in practice—too often for the public to take at its face value M. Bonnet's increase of taxation by 10½ milliard francs, and his reduction of expenditure by 12½ milliard francs. Nevertheless, everybody had to admit that the Government did not lack determination to tackle the budgetary problem, which was more than its predecessor could have said.

Above all, news from industrial quarters was distinctly better. Under the Blum Government the working classes had felt that in their demands, justified or otherwise, against their employers, they could rely on the full support of the executive. Human nature being what it is, they had used and abused their privileged position. Under M. Chautemps, it was no longer quite so certain that official quarters would necessarily support the workmen's claims, however reasonable they might be. An element of doubt crept into the minds of the workmen as to whether they would always be able to have their own way, and their attitude towards their employers became less aggressive. The unions had been losing membership for some months. A large number of French workmen felt that, since by joining the unions they had obtained all they were likely to obtain for the time being, there was no further object in paying the subscription. They resigned, fully prepared to rejoin the unions as soon as there was another drive for higher wages or improved conditions. The result

was that the number of industrial conflicts declined and stay-in strikes virtually ceased. There was, it is true, still the application of the 40-hour week, which was being carried through with a rigidity that inflicted considerable inconvenience and heavy losses upon enterprise. Nevertheless, in isolated instances the workmen and their unions showed themselves willing to compromise, and the industrial outlook was distinctly more encouraging.

(5) Treasury's Unfavourable Position

The degree of improvement during the summer was, however, not sufficient to give rise to optimism. The undertone remained decidedly pessimistic, especially since a reversal of this better trend in the industrial situation was expected in case of the return of M. Blum to office. There was a strong and growing feeling of defeatism regarding the prospects of the franc. It was expected to depreciate to 150 to the pound in the near future, and considerably further in the more distant future. During July and August the French authorities were losing exchange in supporting the franc at its new level. On two occasions when they found the support too expensive they allowed the franc to find its level, and by the end of August the pound was quoted in Paris at 133. The weakness of the franc towards the end of August and at the beginning of September was due to the deterioration of the Treasury's position. The third quarter of the year is usually favourable from the point of view of French revenue, and the fact that it had become necessary to draw upon the facilities arranged with the Bank of France even during that quarter accentuated pessimism regarding the Treasury's prospects.

(6) M. Bonnet's Blunder

The establishment of a special fund for the support of Government securities proved to be a first-class blunder. Every time the franc was attacked there was a natural tendency for Government loans to fall, owing to liquidations by holders desirous of transferring their capital abroad. With the aid of the resources of the special fund, the price of Government loans was kept at an artificially high level. This official intervention put a premium on the flight of capital, which might otherwise have been moderated by the fall in Government loans. After all, if 3 per cent perpetual rentes were allowed to slump to, say, 50, few holders would sell out

merely for fear of a further depreciation of the franc, for the simple reason that if they sold at such a low price they would stand to lose at least as much as through the anticipated depreciation of the currency. If, however, the price of rentes was kept up to, say, 70, then it became worth while for many holders to liquidate their Government loans and transfer the proceeds abroad, in anticipation of a depreciation of the franc. French rentiers desirous of transferring their capital abroad were very conveniently relieved of their holdings at a relatively good price by the Government.

The support of the market in Government loans was a mistake also from another point of view. Whenever there was an attack on the franc, the liquid resources of the money market became very scarce, and their scarcity tended to handicap short selling and the transfer of refugee money and swap money. By buying rentes to amounts running into milliards, the French authorities placed additional milliards in the money market, thereby facilitating the attack on the franc. The disadvantages of this course should have been obvious from the outset. They were pointed out at the time when the special fund was created. Nevertheless, the French authorities persisted in their error until the resources of the special fund were exhausted. This policy was probably the result of a desire to claim credit for an improvement in rentes and thereby to strengthen the Government's political position, notwithstanding the depreciation of the franc.

(7) Stage-management of the Franc

In the course of these months, M. Bonnet showed himself a past-master in the art of political stage-management of the financial markets. Time and again a recovery was allowed to take place in the franc, or was even artificially brought about, to enable the Government to claim credit for the achievement or to accentuate the impression created by its statements. As a result of this policy, the available resources of the French authorities, which were badly needed, were wasted and opportunities for the replenishment of those resources were missed. The milliards used in support of the rentes could have served a better purpose if they had been placed at the Treasury's disposal, thereby obviating the necessity of borrowing from the Bank of France. It was indeed the height of absurdity that, at a time when the Treasury was obliged to borrow milliard after milliard, an attempt should be made to bolster up the

market in Government loans against the unfavourable effect of the huge deficit.

These and many other blunders undermined confidence in the Government's capacity to tackle the financial and monetary problems. In fact, the franc came to be regarded as a doomed currency, and few people were optimistic enough to predict a limit to its persistent depreciation.

CHAPTER XIII

THE CLIMAX

(1) Signs of Demoralisation

In the course of September the crisis of the franc began to move with dramatic rapidity towards its climax. An atmosphere of utter defeatism was beginning to seize the foreign exchange market and the French public. It was felt that there was no hope of arresting the fall of the franc, and a disastrous slump comparable with that of 1926, or even that of the various Central European currencies after the war, was widely anticipated. There was evidence of the growing demoralisation that characterises the advanced stages of currency depreciation. Speculators, having made substantial profits again and again by bearing the franc, were selling short irrespective of cost. The volume of French balances abroad, which had undergone a decline after the devaluation of the franc a year before, rose to new high records.

There was a strong demand for pound and dollar notes for hoarding purposes, and although these notes were transported to France in large consignments, they commanded quite a substantial premium against the sterling–franc and dollar–franc exchange rates. The French authorities did not benefit by the record tourist traffic to anything like the full extent of spendings, since in so far as the foreign visitors paid their bills in their own currencies—they were encouraged to do so by the attractive rates allowed by hotels, restaurants and shops—these notes remained hoarded. What is more, even the salaried and wage-earning classes were getting into the habit of converting their wages into pound or dollar notes, so as to benefit by the depreciation of the franc during the period before they had to reconvert the notes in order to spend the money. Admittedly, this practice was far from universal. There was, however, a danger that it would become popular before very long, and this would have increased the degree of the flight from the franc to a formidable extent.

There was also a revival of hoarding of gold bars, and even more of coins. In fact, the flight to gold which we pro-

pose to discuss in Chapter XXX originated to a large degree as a result of the French situation. Coins once more went to a fantastic premium, and it was hardly possible to satisfy the ever-increasing demand. Once more French hoarders and owners of refugee funds appeared in London, as they did during the summer of 1936, to open new accounts or increase their existing holdings. Obviously the flight from the franc was in full swing.

(2) Mistaken Tactics

In face of this sweeping movement, the attitude of the French monetary authorities was characterised by utter indecision. When M. Bonnet assumed office, his first step was to restore the elasticity of the franc. This, however, did not mean that he allowed the franc to take care of itself, confining his intervention to ironing out unduly violent speculative movements. The franc was allowed to depreciate in jerks. After a heavy fall, it was allowed to recover, and it was then kept pegged against the renewed adverse trend until the next fall became inevitable. This experience was repeated again and again, so that speculators considered it quite safe to base their operations on the assumption that the official tactics would always follow the same lines.

As a result of these tactics, the Exchange Stabilisation Fund, instead of accumulating foreign exchange, used up its resources at an alarming rate. It was evident that before very long the French Government would be confronted with the alternatives of leaving the franc to its own devices or supporting it by withdrawing gold from the Bank of France. The latter's gold reserve was still substantial, and its use would have enabled the French authorities to resist the pressure for a considerable time. There was, however, a growing opposition to the waste of the gold stock upon futile efforts to bolster up the franc. In particular, the French General Staff is said to have expressed its growing concern over the dwindling of France's war chest.

To reassure public opinion in this respect, M. Bonnet committed the major error of declaring his determination not to use the Bank of France's gold stock for the support of the franc. While the decision was right, the public announcement of it was remarkably ill-advised. M. Bonnet's idea in announcing it was presumably to impress the French public with the necessity for making an effort to remove the underlying cause of the weakness of the franc instead of relying

upon the depreciation being prevented or delayed by the use of the gold reserve. He doubtless succeeded in frightening the working-classes and their political leaders, but at the same time he also succeeded in encouraging the flight of capital and bear speculation in francs. In fact, he unwittingly gave speculators a very valuable hint. He virtually informed them that the Exchange Stabilisation Fund was no longer in a position to resist their attacks. The result was the accentuation of the selling pressure on the franc.

(3) Defeatism

The prospects of the franc were viewed everywhere with utter pessimism. It was taken for granted that before the end of the year the Treasury would exhaust the borrowing powers of 15 milliard francs from the Bank of France, and that it would become necessary to arrange for additional inflationary borrowing. The London credit of £40 million was due for repayment at the end of November and during December, and it appeared probable that its repayment would lead to a fresh fall in the gold reserve of the Bank of France. It was widely believed that before the end of the year the franc would be around 200, or even 250, to the pound. The belief that its depreciation would improve the chances of its eventual defence at a lower level was beginning to wear thin. It was argued that the depreciation of the franc was due not so much to monetary causes as to political causes which would remain the same even after the franc had reached 250.

(4) Need for Major Depreciation

And yet there was bound to be a level at which the franc would become attractive to buy. Even though there was no hope of inducing political refugee money to return until the political causes for its flight had ceased to exist, there was a hope that when the franc had reached a lower level a number of French holders of foreign exchange would be tempted to take their profit. Moreover, its depreciation would create an inflationary atmosphere, manifesting itself in growing demand for goods, and the revival of trade thus caused would necessitate the repatriation of capital by industrial interests. Apart from this, since there is always a time-lag between the depreciation of an exchange and the adjustment of the cost of production to its new level, a further depreciation of the franc was bound to improve France's chances of increasing her exports, provided that she could increase her production.

which had suffered considerably through the lack of discipline and through the application of M. Blum's legislative measures.

Above all, a further depreciation of the franc would facilitate the solution of the budgetary problem, since it would reduce the real burden of the public debt. This obvious truth was not adequately realised, even at that stage, in France, although it was beginning to be realised abroad. It was pointed out, even in such orthodox and Conservative quarters as *The Times*, that the solution of the French budgetary problem lay in a further depreciation of the franc. From this point of view the fall of the franc was a necessary evil, or even a blessing in disguise. This aspect of the franc crisis was not, however, adequately appreciated in France, which was, perhaps, as well, since it was the alarmist view taken about the consequences of the continued fall that eventually induced the working-classes to adopt a more conciliatory attitude.

(5) Political Troubles

Internal and international political developments contributed to the universal pessimism regarding the franc. Internally the position of the Chautemps Government was not considered very safe. Apart altogether from the possibility of a breach between Socialists and Radicals, there was also the danger of a crisis through the ambition of M. Bonnet, who was obviously desirous of taking M. Chautemps's place. There was, it is true, much talk about the possibility of bringing about a Government of National Union to take the place of the Chautemps Government, but the chances were heavily against such a coalition. It seemed probable at the time that any change of Government could only result in the return of the Socialists to office.

The international political situation was also becoming increasingly menacing. Developments in Spain and the Mediterranean made war seem at times almost imminent, and this alone was sufficient motive for a number of Frenchmen to play for safety by transferring their capital abroad. The reason why this was not done on a large scale was that most patriots had already placed all their spare funds safely abroad.

Throughout the earlier part of 1937 it had been hoped against hope that the tide of French capital might turn, not as a result of any restoration of confidence but through some anti-hot-money measure taken by President Roosevelt or through agreements reached between the French Government on the one hand and the United States, British and other

Governments on the other for the disclosure of French assets abroad. Although the possibility of such an agreement with the United States was repeatedly foreshadowed, nothing was actually done about it. The prospects of concluding agreements with the British Government were even less promising, while there seemed to be no chance whatsoever of inducing the Swiss authorities to disclose the ownership of refugee funds. By September it seemed fairly obvious that nothing could be hoped from that direction.

(6) Government and Exchange Restrictions

In the circumstances the adoption of exchange restrictions as an alternative to the further immediate depreciation of the franc had to be envisaged once more. To some extent the Government yielded to pressure in favour of exchange restrictions, in that it re-introduced an unofficial embargo on speculative foreign exchange transactions. In an excess of zeal this measure was at first applied so rigorously that forward exchange dealing in Paris came virtually to a standstill. The result was not an appreciation of the forward franc, as the French authorities had anticipated, but a further widening of its discount. This should have been obvious to M. Blum or his advisers, since the embargo on forward exchange transactions in Paris did not stop speculative selling in foreign centres by Frenchmen and foreigners alike. What it did stop was the buying of forward francs by French banks engaged in interest arbitrage. As it became difficult for speculators to find a counterpart, the discount inevitably widened. The psychological effect of the embargo on forward operations in Paris was also considerable. The widening of the forward discount was regarded as an alarm signal, and the effect of the embargo itself was thought to foreshadow the adoption of all-round exchange restrictions. For this reason it accelerated the outflow of capital.

In reality the fear that the official embargo would be followed by the adoption of exchange restrictions proper was not justified. MM. Chautemps and Bonnet were as determined as ever not to resort to exchange restrictions. M. Bonnet explained his attitude by pointing out that since most of the liquid capital of France had already been sent abroad, there would not be much sense in locking the stable door after the horse was gone. In this respect he was guilty of the same error as several of his predecessors. At the end of 1935 M. Laval was convinced that there was hardly any

French capital left to take refuge abroad. Since then the loss of many milliards of francs' worth of gold by the Bank of France has shown that his judgment was faulty. What M. Bonnet appeared not to realise was that so long as the French Government and the Bank of France manufactured funds through the budgetary deficit and its inflationary financing, it was utterly hopeless to expect that the funds available for export abroad would dry up. Nor did they take into account the huge amounts of franc notes hoarded by the public, which were also available for conversion into foreign notes. Whether M. Bonnet was right or wrong in refraining from adopting exchange restrictions, he certainly gave the wrong reason for his decision.

(7) The Climax of October

Early in October the franc crisis reached its climax; the sterling–franc rate rose to 152. This was a record for all time, in spite of the fact that in the summer of 1926 the sterling–franc rate reached 250, for in the meantime sterling itself had depreciated considerably; allowing for this, the gold value of the franc at the beginning of October 1937 was lower than at any previous time in history. This consideration resulted in some bear covering, for it was thought possible that the tide would turn again, as it had in 1926. After its heavy slump the franc settled for a few days in the vicinity of 150 to the pound.

Thus the rate of 150, which was one of the favourite forecasts, was actually reached. What surprised most people was the comparative calm with which this slump of the franc was received by the French public. It had been widely expected that such a heavy depreciation of the exchange could not possibly take place without being accompanied by an all-round financial and economic panic and collapse. It was even feared that the franc slump would lead to internal disturbances and even to civil war. Both friends and enemies of France abroad watched the situation, fully expecting it to react upon the international balance of power. It was hoped, or feared, as the case might be, that as a result of the franc crisis, France might become virtually eclipsed as a first-rate power, since she would be too much pre-occupied with her internal troubles to play any important part in the international field.

Fortunately the prophets who expected such developments proved to be utterly wrong regarding both the effect of the

franc slump upon France and its international repercussions. The subsequent slumps of the exchange were received by the French public with praiseworthy calm. There were no panicky scenes, even on the Bourse, and much less in the country as a whole. The situation was incomparably calmer than it had been during the first few months of the Blum régime, when the atmosphere was distinctly fraught with the danger of a revolution and civil war. What the pessimistic prophets did not realise was that while revolutions usually make for inflation, a moderate inflation is the best way to avoid revolution. It is not inflation, but deflation and resistance to a depreciation of the currency that is apt to lead to civil war. Had the Government continued to bolster up the franc at 105, by September France would probably have been in the throes of a political upheaval. It would have been impossible to pass on to the purchaser the rise in prices due to the application of the 40-hour week, and industrial undertakings would have had to close down or reduce their activity. The wholesale increase of unemployment would have created discontent and street riots leading to grave disturbances. Like the devaluation of the franc in 1936, its depreciation in 1937 was a lightning-conductor which saved the country from disaster.

(8) A Blessing in Disguise

The depreciation of the franc was a blessing in disguise from the point of view of the position of France as a factor in international politics. Had the stubborn resistance to depreciation led to internal disturbances, this would inevitably have reacted upon the efficiency of national defence and would have given the Berlin–Rome axis its supreme chance either to strike out against a weakened France or to strike out in other directions, on the assumption that France would not be in a position to come to the assistance of her friends. The depreciation of the franc obviated this danger. Since at these later stages it was not accompanied by any further decline of the gold reserve of the Bank of France, it did not even weaken the war chest. The fact that the franc was quoted at 150 instead of 105 did not reduce the number of troops actually and potentially at the disposal of the French General Staff, nor did it weaken the efficiency of their equipment. On the contrary, had an attempt been made to continue pegging the franc at 105, it would have necessitated rigid economies even in the sphere of national defence. As

it was, such cuts as were made in French national defence expenditure were moderate. Economy in that direction consisted mainly of preventing any further increase in expenditure rather than of cutting down the amounts already authorised.

Even though the franc slump did not lead to any disastrous economic or political consequences, the French Government should not escape criticism for the mismanagement of that movement. It ought to have realised that the chances of putting up resistance at the various stages between 105 and 150 were negligible. Instead of prolonging the agony, it ought to have depreciated the franc at one swift stroke, bringing it to a level at which there was a chance of its defence without undue sacrifices. It is difficult to say whether the unwillingness of the French Government to adopt such a policy was due to lack of foresight or lack of courage. However it may be, the Government was reluctant to retreat until it was forced to do so by irresistible pressure. It may be that it would have been difficult from a political point of view to act otherwise. Nevertheless, the advantages of avoiding the series of shocks, and of safeguarding the gold resources which were used up in the effort to delay the fall, would have made it worth while to put up with the political disadvantage of a deliberate and swift depreciation.

CHAPTER XIV

SURPRISE RECOVERY

(1) The Rambouillet Declaration

By the beginning of October, most people had abandoned hope of checking the non-stop fall of the franc. And yet by the middle of the month the franc had undergone a remarkable recovery. The change was as unexpected as it was welcome to all but the bear speculators, but it came at the most advanced stage of the slump of the franc. It is not the first time in history that an exchange which was considered doomed has suddenly undergone a miraculous improvement almost overnight. Twice during the post-war years, in 1924 and in 1926, there was a similar turn in the trend of the franc at a time when most people were inclined to believe that it would share the fate of the German mark.

The starting-point of the turn in the tendency of the franc on this occasion was the Cabinet council held at Rambouillet in October. In anticipation of the meeting of that council, there was heavy selling for fear that it might decide to devalue the franc further, or to introduce exchange restrictions. It was with much relief that the public learned from the statement issued after the Cabinet council that the Government had taken neither course. The most important point of the statement was that the Government had decided to enforce discipline in industry and to modify the application of the 40-hour week in a sense calculated to be less detrimental to production. The significance of the statement was that it was issued in agreement with the Socialist members of the Government. Apparently M. Blum and his colleagues had agreed that, in practice if not in law, the social reform movement which they had initiated should be reversed to some extent, and that the power of the executive should be wielded impartially between employers and employees, instead of indiscriminately in support of the latter.

(2) Socialists' Conciliatory Attitude

The immediate effect of the Rambouillet statement was not very pronounced. The foreign exchange market and the public preferred to await developments to see how the rank and file of the Socialist party would receive this change of policy. It was feared that M. Jouhaux, the head of the Trades Union Council, would oppose it to the utmost, and that the Communists would make use of it for agitation against the Government. It was also feared that the workmen would be reluctant to relinquish the power they had acquired by the use of the weapon of stay-in strikes, and that the Government's position would be challenged by a new epidemic of such strikes.

A week passed after the Rambouillet statement and nothing of this sort happened. The country remained calm and there was no strong opposition to the Government's decision from any section of the Socialist party. M. Jouhaux himself behaved with statesmanlike calm and even the Communists failed to make political capital out of the Government's decision. The explanation of this attitude lies partly in the international political tension and partly in the fact of the franc slump. The Socialists and Communists realised at last that by pursuing a course tending to disorganise French production, they would be playing into the hands of the Italian and German Governments. The Mediterranean outlook appeared to be very dangerous, and in the circumstances M. Jouhaux and the other extremist leaders preferred to abstain from embarrassing the Government. Their attitude was also influenced by the fear of a really disastrous slump of the franc. What happened in France in October 1937 can be compared with what happened in Great Britain in 1931, when a number of Labour politicians and a large number of Labour voters supported a mainly Conservative Government for fear of a slump of the currency. In France the Front Populaire Government did not become "Macdonaldised"—to use the term popular in the French Socialist Press—but merely adopted a more moderate policy.

(3) Recovery of the Franc

From October 10 onward, the franc became distinctly firmer, and underwent a gradual appreciation. Had the French authorities not intervened, it would probably have recovered to something like 140 to the pound. It would have been a fatal mistake, however, to allow such a recovery, since the

franc would not have been able to hold the improvement. As it was, the French authorities did not sufficiently resist recovery. They ought to have maintained the franc at about 150, or at any rate have allowed it to recover at the rate of only a few centimes a day. Instead, they allowed it to recover by a quarter or half a franc a day until the sterling-franc rate declined below 147. In resisting a too sudden appreciation the French authorities were able to accumulate substantial amounts of foreign exchange. They would have been able to accumulate much more, however, if they had held the rate at 150. Their policy in allowing the franc to recover to some extent was all the more unjustified as it was by no means certain that the recovery would be lasting. There were still many thunderclouds in the air, and it required a high degree of optimism to expect that the franc would be able to retain its recovery.

Fortunately for France, the international factor turned at that stage decidedly in her favour. The repatriations brought about by the moderate revival of confidence concerning the industrial situation became accentuated as a result of the flight from the dollar, and the general deterioration of conditions on foreign Stock Exchanges. Until about August, the gloomy position and prospects in French trade were in sharp contrast with the reasonably satisfactory outlook in Great Britain, the United States, Holland, Belgium, Switzerland, etc. There was every temptation for French capital to seek investment in those countries, apart altogether from the unfavourable prospects of the franc. But the Wall Street slump, accompanied by minor slumps in London, Amsterdam and elsewhere, and the less favourable trade outlook, induced much of the French capital invested abroad to return to France. It was felt that France had more or less got over most of her troubles, while the difficulties of other countries were only just beginning.

(4) Favourable Changes

The recovery of the franc was accompanied by a fair amount of dishoarding of foreign notes hoarded in France. Large amounts of pound notes found their way back to London, and the amount of French balances abroad declined slightly. There was a fair amount of French selling of stocks in London and New York, and the proceeds were partly repatriated. There was also much bear covering, and the discount on forward francs became gradually reduced to almost normal proportions.

The Treasury's position also improved. M. Bonnet suc-

ceeded in carrying through a conversion operation and in raising loans in Switzerland and Holland for the French railways. After having drawn upon the new facilities arranged with the Bank of France to the extent of about 5 milliard francs in the late summer, the Treasury succeeded in meeting its liabilities without having to increase its advances any further. How this was done is a mystery, since the current deficit remained substantial in spite of M. Bonnet's economies and additional taxation, most of which was not to produce its full effect until 1938. Presumably the arrears in Treasury payments increased. Government contractors had to wait longer before receiving payment for their deliveries, and meanwhile had to be financed by the banks. From the point of view of trade, this was anything but satisfactory, since credit was none too plentiful and the banks were charging something like 8 per cent on advances. Nevertheless, the absence of any increase of borrowing from the Central Bank created a good impression and helped the recovery of the franc.

Nothing succeeds like success. The improvement in the trend of the franc was accompanied by better news about the industrial situation. The number of strikes had declined and the workmen had adopted an altogether more conciliatory attitude. In many instances industrial disputes were settled amicably on terms which a few months before would have been considered inconceivable. Hopes were entertained that the deadlock over the application of the 40-hour week would be solved by retaining the principle while increasing the number of working hours in practice to 45 and paying overtime for the extra hours. This solution was expected to kill two birds with one stone, since it would also satisfy demands for higher wages, demands which were becoming more insistent owing to the rise in the cost of living.

The deflationary trend that set in abroad was in a way also helpful to the French Government. In the absence of a fall in commodity prices in the world markets, a further rise in French commodity prices would have been inevitable as a result of the recent depreciation of the franc. As it was, French prices remained more or less stable while those abroad were falling.

(5) Repayment of London Credit

Even in this better atmosphere, the question of the London credit of £40 million gave rise to much concern. The Swiss and Dutch loans covered only a small part of the amount

required, and it was feared that the repayment of the credit would lead to a heavy fall in the gold reserve of the Bank of France. Opinion was fairly evenly divided as to whether the French Government would make an effort to obtain a renewal of the credit or would repay it. The London banks were not very keen on renewing it, since in the meantime the demand for advances by trade had increased considerably, and they were able to find profitable employment for their resources at home. In any case, they were not altogether satisfied with the informal security for the credit, and most of the participants would have insisted on a watertight legal security. This would have been unacceptable to the French Government, since it would have necessitated the exclusion of the gold from the Bank of France's gold reserve. The transaction would have amounted to using their own gold and paying interest on it, obviously an unsatisfactory solution. Accordingly the French Government decided not to press for a renewal of the credit.

When the Government's decision to repay the credit was announced, it was feared that the result would be a weakening of the newly acquired foreign exchange stock of the Exchange Stabilisation Fund. Apparently, however, the amount acquired during October and November had been larger than most people supposed. As a display of its strength, the Exchange Stabilisation Fund in November even transferred a large amount of gold to the Bank of France. This created a reassuring impression, and further strengthened the franc, which by that time had become almost rigidly pegged a shade above 147.

Within a few weeks after the climax of the franc crisis, the position of the franc appeared to have become thoroughly consolidated. Admittedly, the more distant prospects continued to be viewed with some uneasiness. It was feared that the political truce was too good to last. The view was widely held, however, that barring political complications, the franc might be regarded as being reasonably safe, at any rate for some time to come. For the first time since 1935 it was considered possible to regard the immediate prospects of the franc with guarded optimism.

PART IV

REARMAMENT FINANCE

CHAPTER XV

REARMAMENT AND MONETARY POLICY

(1) A Fundamental Factor

The year 1937 witnessed the advent and departure of various major trends. We saw in Part II that a violent gold scare developed during the second quarter and disappeared at the beginning of the third quarter of the year. We also saw, in Part III, that there was a series of franc crises, culminating in a climax in the autumn of 1937. We shall see in later chapters that there was in the autumn an "inverted gold scare", a dollar scare and a trade recession. While these important phenomena came and went, there was one underlying factor which was present all the time. This factor was rearmament. Its influence may have been overshadowed from time to time by other factors, but even then it was impossible to ignore its existence. It affected to no slight degree the financial and monetary policy of a number of countries.

(2) Rearmament in Germany and Italy

The extent of the influence of this factor, and the time of the beginning of its operation, varied from country to country. It was in Germany that rearmament first assumed a predominant character. Soon after the advent of the National Socialist régime, Germany embarked upon wholesale reflation, largely as a result of the Government's desire to rearm in haste. So long as rearmament had to be kept more or less secret, its extent was comparatively moderate. When, however, Germany decided to discard pretence and rearm openly, the amount spent for that purpose reached spectacular dimensions. Notwithstanding this, the reichsmark was nominally maintained at par, and the adverse effect of reflationary rearmament upon the trade balance was more or less counteracted by a series of artificial devices applied in the sphere of foreign trade and exchange. It was largely as a result of the reflation embarked upon for the sake of rearmament that Germany's economy to a large degree lost contact with world economy.

The next country to subordinate its monetary policy to the requirements of rearmament was Italy. The Abyssinian campaign was undertaken largely in order to divert the attention of the Italian public from the adverse effect of a mistaken deflationary monetary policy. Once preparations for the Abyssinian campaign began in earnest, monetary policy had to adjust itself to the requirements of that gigantic undertaking. The lira was gradually allowed to depreciate to a fairly considerable extent, even though in theory it was still supposed to be at par with the Gold Bloc currencies. In the course of the Abyssinian campaign reflation through rearmament assumed considerable dimensions, but it was artificially prevented from producing its effect upon the exchange rate. As in Germany, so in Italy, artificial devices were applied to maintain exports in face of the overvaluation of the currency. In the case of Italy, the situation was further complicated by the adoption of sanctions. Nevertheless, the influence of the rearmament factor was evident. Eventually, in October 1936, it led to the devaluation of the lira.

(3) Rearmament in Great Britain and France

Great Britain was the next among the leading countries to come under the influence of the rearmament factor. This factor operated to a much smaller degree here than in either Germany or Italy, and failed to affect monetary policy in a positive sense. In a negative sense, however, it led to the prolongation of the cheap-money policy at a time when as a result of trade recovery the Government would otherwise have allowed interest rates to rise.

The growing demand for raw materials in connection with rearmament would inevitably have led to a depreciation of sterling, but for the capital movements which offset the effects of the increasingly adverse trade balance. The desire to maintain cheap money for the sake of financing rearmament led the Government to adopt an attitude tending to discourage trade boom and Stock Exchange boom, without the application of the conventional brakes of bank rate and credit restrictions.

French monetary policy was also powerfully influenced by the rearmament factor. It was largely owing to rearmament requirements that the budgetary deficit became incurable. It was rearmament expenditure which increased considerably the difficulties of the French Treasury in meeting its requirements by normal borrowing. It was the inflationary financing

of rearmament expenditure that contributed more than any other single factor to the development of a situation in which there was no choice but to devalue the franc.

(4) Rearmament in Other Countries

Outside Europe, Japan came considerably under the influence of the rearmament factor. As a result of rearmament, even before the actual outbreak of the war in China, the Japanese trade balance became increasingly adverse, especially as the yen was not allowed to adjust itself to the rising internal price level and cost of production.

Rearmament in Soviet Russia was probably largely responsible for the speeding-up of the gold production, and heavy gold exports were undertaken for the sake of placing armament orders abroad. It therefore produced considerable repercussions upon the international monetary trend, since it was largely responsible for the gold scare, with all its consequences.

The rearmament factor also affected the smaller European countries and many countries outside Europe. It assumed an almost universal character, even though its influence in the United States was, up to the end of 1937, very moderate.

(5) Full Effect of Rearmament Temporarily Neutralised

The results of the rearmament race were the gross unbalancing of budgets; the development of open or disguised inflation; the development of an adverse trade balance by a number of countries; a tendency of various exchanges to depreciate; an increase of the burden of indebtedness; a tendency for long-term interest rates to rise; and a rising trend in prices and costs. By the end of 1936 these various trends were in full swing. It appeared as though rearmament would constitute the leading factor throughout 1937. It seemed reasonable to expect the reflationary forces put into operation by rearmament to develop to an increasing degree, leading to a further rise in commodity prices, further depreciation of exchanges and further expansion of trade activity. Indeed, such effects were to a large degree anticipated during the last quarter of 1936 and the first quarter of 1937.

Had the anticipations materialised in full, this would have gone a long way towards correcting the disequilibrium due to excessive indebtedness. The fall in the internal and international value of the currencies would have done much to reduce the real burden of public and private indebtedness.

The right solution would have been arrived at for the wrong reason.

There can be no doubt that in the long run rearmament will operate in this sense. In the course of 1937, however, its effect was temporarily neutralised by other factors. The fundamental trend nevertheless existed. It actively operated to a large degree in France, and there is reason to believe that its cancellation in other countries, whether by other factors or by official policy, has been purely provisional.

(6) Rearmament and Fundamental Readjustment

Needless to say, the rearmament race is a highly unsatisfactory method of adjustment of the disequilibrium. If, instead of spending milliards on weapons of destruction, the Governments had spent the same amounts for constructive purposes, for the increase of capital goods and consumption goods, the disequilibrium between fictitious wealth and real wealth would gradually have been reduced, largely by the increase in the volume and value of the latter. As it is, the only way in which rearmament contributes towards the process of readjustment is by tending to raise commodity prices, without increasing the volume of real wealth through the increase of the nominal amount of the indebtedness.

It is doubtful, however, whether any Government would have spent so persistently and on such a scale for any purpose other than national defence (a euphemism which covers, in more than one instance, national aggression). Even President Roosevelt, having for years spent milliards on public works, became converted to orthodoxy in 1936, long before the rise in commodity prices had attained a sufficiently advanced stage adequately to reduce the burden of indebtedness. It was only in face of the requirements of national defence that considerations of financial orthodoxy became overshadowed everywhere, although to a varying extent. In some countries the basic principle was adopted that the output of destructive weapons should be limited only by the physical limits of productive capacity, and the pace at which rearmament should proceed should be determined not by financial considerations but by the capacity of plant, the number of hands, skilled or unskilled, available, and the amount of raw material at the disposal of the Governments. The principle has been found quite workable, much to the astonishment of orthodox economists.

(7) "Money Always Obtainable for Armaments"

Reduced to a simple formula, money has always been obtainable when required for armaments. This was the case both in the countries which had only a very limited amount of accumulated savings available and in countries whose public debt was already grossly excessive. Even before the beginning of rearmament, Germany was struggling with a budgetary deficit, a fact which did not, however, prevent the National Socialist Government from spending many milliards on rearmament. In Great Britain it was decided that the public debt should be increased from its staggering figure of nearly £8 milliard by another half-milliard in the course of five years. Countries such as Roumania, Turkey, and Yugoslavia, which found it difficult to raise quite small amounts for important current requirements, unhesitatingly decided to spend many times larger amounts for rearmament.

The modern monetary and credit system has certainly removed the financial limitations of warfare. If Prince Eugene of Savoy lived to-day, he would not attribute such paramount importance to the possession of financial resources for the conduct of warfare. Once the determination is there, money can always be found, whether through the printing press or through other methods of voluntary or compulsory loans. It is true that even in the days of Prince Eugene, long before the modern financial machinery came into existence, financial considerations did not limit the length of wars, which, to use the words of Wallenstein, "fed themselves" to a large degree. There were thirty years' wars and hundred years' wars long before the printing press came into being and long before authoritarian Governments were able to compel their subjects to relend to them the money spent on rearmament as soon as it had been spent. It would not, therefore, be altogether fair to blame the modern credit system for enabling wicked Governments to prepare acts of aggression and at the same time enabling their prospective victims to arm themselves against these acts of aggression.

In the following chapters we shall see how in the course of the year under review the leading countries have solved their problems arising from rearmament finance. In Part V we shall survey the working of different aspects of rearmament finance in countries which are actually engaged in warfare.

CHAPTER XVI

FINANCING BRITISH REARMAMENT

(1) Taxation *v.* Borrowing

As a result of the Anglo-Italian tension over Abyssinia, the British Government resolved to make good the deficiencies in British armaments due to the policy of disarmament pursued ever since the war. Its decision received the endorsement of the country at the General Election of November 1935. Notwithstanding this, rearmament proceeded throughout 1936 at a very leisurely pace. The amount of expenditure involved was relatively small, and its financing presented no unduly difficult immediate problems. Nevertheless, the possibility of expenditure on an increasing scale had to be envisaged, and the methods of financing to be employed were therefore subject to much discussion.

There were two main schools of thought. According to the one, the Government should cover rearmament expenditure by raising taxation. According to the other, rearmament represented capital expenditure and should be covered by borrowing; not until this country had caught up with its potential opponents could the maintenance of its armed strength be regarded as current expenditure and be financed out of current revenue. Those who demanded that rearmament should be financed entirely out of taxation—known under the name of the " taxing-ourselves-to-the-bone " school—were in favour of this method as an alternative to breaking the boom by means of high bank rate and credit restrictions. Having realised that the Government was not prepared to lend itself to monetary deflation, they hoped to attain the same end by means of budgetary deflation. They did not specify what kind of taxation they had in mind, but presumably wanted the bulk of the funds to be raised by the traditional British method of increasing income tax. Possibly they may have been in favour of raising indirect taxation, as a means of cancelling out the additional purchasing power created through rearmament in the form of higher wages.

It was evident from the very outset that the Government

would not follow the advice of this school of thought, and that at least a large part of the rearmament expenditure would be met by means of borrowing. In fact, it was largely in order that the Government should be able to borrow at a cheap rate that the cheap-money policy was maintained even after the depression had come to an end. While higher taxation was generally envisaged, and in any case the yield on taxation was expected to rise as a result of better trade, it was evident that, once rearmament was in full swing, this additional revenue could cover only a fraction of the exceptional requirements. Nor was there any hope of cutting down expenditure in other directions to any appreciable degree. On the contrary, in order to placate Labour opposition to rearmament, it was necessary to spend on social services, if anything, more than had been spent before rearmament began.

(2) Long-term *v.* Short-term Borrowing

Regarding the method of borrowing, there were again two schools of thought. According to the one, it would be a wise course to issue a large rearmament loan. According to the other, the Treasury should finance rearmament, for some time at any rate, by increasing the floating debt. There was much to be said for both courses. Under the influence of the tension in the Mediterranean it might have been possible for the Government to appeal to the patriotism of the public and raise a large loan on favourable terms. The main objection to this course was that a reduction of the floating debt through the issue of such a long-term loan would have produced a deflationary effect. It was also pointed out that even in the most favourable circumstances the interest on such a long-term loan would have to be much higher than the rate paid on Treasury bills which the loan would replace.

Indeed, from the point of view of the immediate cost of borrowing, there was a great deal to be said in favour of financing rearmament with the aid of additional Treasury bill issues. The market could easily have absorbed several hundreds of millions of pounds' worth of Treasury bills without any undue rise in bill rates. Taking a long view, however, such an increase in the volume of the floating debt was regarded with uneasiness in many quarters, including the Bank of England. While Radical economists, headed by Mr. Keynes, were in favour of de-funding a large part of the consolidated debt in order to save interest, orthodox quarters were all for reducing further the existing amount of Treasury bills. For essentially practical

reasons the discount market was strongly opposed to such a reduction, since the volume of bills was hardly sufficient to go round. Nevertheless, during 1936 the Treasury pursued a policy of reducing the volume of Treasury bills not through the issue of a National Defence Loan but through an inconspicuous consolidation operation. The result of that transaction was anything but favourable and the Public Departments found it difficult to unload the stock which was not wanted by the market. The Treasury's assumption that, if the volume of Treasury bills were reduced, the banks and other former holders would have to reinvest their funds in long-term Government securities received no confirmation from this experience. This mistaken assumption was partly responsible for the weakness of the gilt-edged market during the early months of 1937. Everybody knew that the Public Departments still had large amounts of the last loan to unload, and for this reason the gilt-edged market had a weak undertone. It became the easy victim of every adverse influence.

(3) Dear-money Influences

By the end of 1936 there was a strong and widespread feeling that the cheap-money era was drawing to an end. The Government was no longer as emphatic as it had been earlier in re-affirming its determination to continue this policy; in fact, for some time from December 1936 onward it failed to make any reassuring statement to that effect. As a result, dear-money propaganda went ahead uncontradicted. Day after day it was stated and restated in the City columns and University chairs that a rise in interest rates was inevitable and necessary. High interest rates were declared to be the natural consequence of the trade revival, as a result of which there was more demand for credit. As a matter of fact, the extent to which bank advances had increased by that time was comparatively small—in fact, clearing banks were beginning to be worried by the absence of adequate demand for additional credit accommodation. In any case, there was no technical reason why an increase in the demand for credit accommodation should not be accompanied by a corresponding degree of credit expansion should the authorities wish to prevent a rise in short money rates.

What was much more dangerous from the point of view of the maintenance of cheap money was the effect of the boom in commodities and equities upon the long-term interest rates. A rise in commodity prices, if persistent and substantial,

reduces the real rate of interest earned on fixed-interest-bearing securities, as distinct from their nominal rate of interest. Since investors are not likely to be satisfied with a lower actual yield on Government securities at a time when they have a chance to obtain a higher yield on industrial shares, in the long run nominal interest rates will have to rise in order that real rates of interest may at least remain unchanged.

(4) Adverse Trend in Gilt-edged Market

It takes a long time, however, for investors to realise the decline in the real rate of interest on their investments. This factor does not as a rule operate until after a prolonged period of rise in the cost of living. Before it begins to produce its effect, a rise in equities tends to bring about a fall in Government securities. The prospects of higher yield on industrial shares, and especially the prospects of capital appreciation, tend to divert capital from the gilt-edged market to the industrial market.

In addition to this fundamental factor, there were other factors in operation. There was in the first place the inexplicable deflationary action of the Bank of England in January 1937. At a time when, owing to seasonal considerations, the right policy would have been to expand credit by buying Government securities, the Central Bank, for some obscure reason, was selling securities, thereby reducing bank cash. As a result, banks were inclined to sell rather than to buy Government securities at a time when sellers were in any case predominant in the gilt-edged market. The object of this deflationary move was never made clear. Quite conceivably it was nothing more than a blunder.

The revival of trade was also partly responsible for the weakness in the gilt-edged market, since industrial undertakings liquidated their investments in order to finance their expansion. This was one of the reasons why the trade revival was not accompanied at that stage by an increase in bank advances. In previous years, industrial and commercial undertakings had succeeded in accumulating substantial reserves which they invested mostly in Government securities. Now that they needed the cash, they preferred to liquidate their holdings, especially as there was a widespread and deliberately fostered pessimism regarding the prospects of the gilt-edged market.

The time-lag between the passing of rearmament orders to Government contractors and the payment for deliveries was

also responsible for the weakness in Government loans. In some instances when it was necessary to erect new plant, the Treasury advanced a large part of the amount required. In other instances, however, Government contractors had to wait six to eight months after having delivered the goods before their accounts had passed through all the stages of auditing and were eventually paid. In the meantime they had to finance their activities somehow, and to a large degree this was done through the liquidation of their Government stocks.

(5) Blunder of National Defence Loan Announcement

The final decisive blow was delivered at the gilt-edged market by the announcement of the Government's intention to issue a National Defence Loan of £400 million. This was easily the biggest financial blunder of the Government for years. It is difficult to believe that the Treasury was responsible for it. The permanent officials in charge of Treasury operations have acquired a well-deserved reputation for skill and competence. It is inconceivable that they should not have been aware of the probable effect of such an announcement on the market. What probably happened was that the Government wanted to make a gesture for international purposes. Presumably it expected the announcement of a rearmament loan of nearly half a milliard to impress Germany and Italy and to induce them to adopt a less aggressive attitude. If this was the object of the announcement, it fell completely flat, for it was made plain that the borrowing of the £400 million would be spread over five years. The Government must have been very ill-informed about the amounts which Italy, and even more Germany, were spending on rearmament if it thought that a paltry £80 million a year would overawe the two dictators. Between them they probably spend in one single year more than £400 million. This being so, it is not surprising that as far as they were concerned the announcement did not produce the desired effect, and that it failed to frighten them into adopting a more conciliatory policy. In fact, during the months that followed the announcement the attitude of Berlin and Rome became more and more aggressive.

Thus the political object of the announcement of the National Defence Loan was not achieved. At the same time the loan produced a most unfavourable effect on the gilt-edged market, which was in any case rather weak at the time. It is a wonder that the slump in Government securities that followed the announcement of the loan was not even more disastrous.

Presumably it would have developed further but for the reversal of the trend in trade and commodities brought about by the gold scare. Even as it was, the gilt-edged market was out of favour and was viewed with distrust for many months after the fatal announcement. This unfavourable result was all the more deplorable since it was by no means unavoidable. There was no need whatsoever for the Government to announce in advance its plans of borrowing for five years ahead, or to seek special powers from Parliament for the issue of the whole £400 million, when only a small part of the amount was needed immediately. It would have been quite possible to go ahead with the financing of rearmament as requirements arose, without having to secure in advance Parliament's approval, which in any case was easily forthcoming.

(6) An Ill-timed Decision

Evidently the Government chose the worst of both worlds. It decided to bring out a large National Defence Loan without taking advantage of the patriotic appeal of such a transaction. When in April the first instalment of the National Defence Loan was issued, it was not accompanied by any propaganda to induce investors to take it up, and in any case the type of medium-term loan chosen was not one which was likely to appeal to the general investor. The time of the announcement of the National Defence Loan was also most unfortunate, since it came when the undertone of the market was in any case very weak. Six months earlier or six months later the announcement would have done little damage. As it was, it was made in circumstances in which its adverse effect became accentuated to the extreme. The Government certainly made a bad start with rearmament financing, and it took some time for it to live down the adverse consequences of its initial blunder.

(7) Dear-Money School's Triumph

For the time being the dear-money school was triumphant. It appeared as though their dream of dreams had come true and the object of their hatred, the cheap-money policy, would have to be abandoned. It was freely predicted in orthodox quarters that by the end of the year Government loans would be on a "sound" 4 per cent basis, and the bank rate would have risen to 3 per cent. Apart from a small number of orthodox City Editors, economists and bankers, nobody had any cause for rejoicing. The outlook for rearmament financing

was becoming very gloomy indeed. In itself the increase of the cost of borrowing would not have been a major disaster, although it added to the already heavy burden of public debt. The danger was, however, that the gilt-edged market might dry up altogether. During the slump the absorbing capacity of the market was very small indeed, and comparatively small sales were sufficient to bring down prices. In such conditions, the prospects of placing £400 million of additional Government loans were none too bright. Those in favour of dear money argued that once the yield had settled down around 4 per cent, the absorbing capacity of the market would increase. This was assuming, however, that banks and investors regarded the 4 per cent as definite, and did not expect a further fall in Government loans. There was nothing to prevent the dear-money school, after having achieved their aim of talking up the yield to 4 per cent, from setting out with an increased appetite to talk it up to a " sound " level of 5 per cent.

The situation was becoming dangerous and might have become disastrous but for the good British habit of not recognising defeat. In the autumn of 1931 the slump of sterling did not proceed very far because the British public refused to believe in it, and in the same way during the spring of 1937 the slump in the gilt-edged market did not proceed very far because of the fundamental faith of the British public in Government securities. Nevertheless, it became obvious that drastic measures were required in order to keep the gilt-edged situation well in hand.

CHAPTER XVII

MR. CHAMBERLAIN'S BOMBSHELL

(1) Government and Rearmament Profiteering

Until April 1937 it seemed as though the advice of the "taxing-ourselves-to-the-bone" school had been completely disregarded in Whitehall. In particular after the announcement of the £400 million National Defence Loan scheme it was generally assumed that rearmament would be financed almost exclusively by means of borrowing. On these grounds the Government was subject to scathing attacks from the Opposition, who represented Mr. Baldwin and, to a much larger extent, Mr. Chamberlain as the supreme protectors of rearmament profiteers. We grew quite accustomed to seeing Mr. Chamberlain in a top-hat, in Low's cartoons, fraternising with fat, sinister-looking armament manufacturers. I myself plead guilty of having misjudged the National Government in the same way. In *World Finance, 1935–1937*, I criticised the Government for having done nothing to prevent direct or indirect armament profiteering.

It was generally believed that the budget for 1937–8 would contain no startling alterations. Some quarters expected another small addition to the income tax or similar minor adjustments, but nothing in the way of a drastic increase of taxation to cover rearmament expenditure.

(2) The National Defence Contribution

In the circumstances Mr. Chamberlain's announcement, in his budget statement, of his decision to revive the war-time Excess Profit Duty under the name of National Defence Contribution, came as a bolt from the blue. It was something unheard of in time of peace for a Conservative Chancellor of the Exchequer, who was a prospective Prime Minister, to levy a special tax on exceptional profits. And since Mr. Chamberlain had the reputation of being even more Conservative than Mr. Baldwin, it was the last thing he was expected to do.

In substance the scheme amounted to levying a tax of

between 12 and 30 per cent on the additional profits earned compared with the average for the basic years 1933–4, 1934–5 and 1935–6. As Mr. Chamberlain announced, the Exchequer did not expect to receive more than £20 million from this new source of revenue during the first year of its application. This statement in itself indicated that the Government intended to apply the new tax leniently, and Mr. Chamberlain repeatedly emphasised his readiness to make exceptions when the application of the tax would result in undue hardship.

(3) Violent Opposition

Nevertheless, the announcement of the National Defence Contribution brought forth a flood of violent protest from all those who were likely to be subject to the new tax. The City simply burst into hysterics. Part of the Press showered torrents of abuse on the Chancellor of the Exchequer, who was at the same time bombarded by memoranda and deputations from the various industrial and commercial organisations. The almost moribund "Industrial Group" in the House of Commons—popularly known as the Forty Thieves—was galvanised into life and mobilised all its influence and connections to bring pressure to bear on the Government. The Stock Exchange, which was in any case in a bad mood owing to the gold scare, witnessed a heavy slump, and hundreds of millions of pounds of capital value was wiped out in one day through the fall in industrial shares. Investors and speculators lost all their sense of proportion and their common sense in estimating the incidence of the new tax upon various companies. Admittedly, in the case of some companies whose profit had increased materially during 1936–7, the amount of the new tax would have been substantial. In other instances, however, the value of shares was written down materially, even though the extent to which they were likely to be affected by the new tax was negligible.

The whole movement amounted to a "Rich Men's Revolt" against a Government bold enough to levy a tax on them. Capital and enterprise considered themselves fully entitled to the full benefit of the additional profits which had accrued through the Government's policy of reflation and rearmament, without feeling in any way obliged to cede a fraction of that additional profit to assist in the financing of national defence. The Press trembled with indignation when writing about the dastardly attempt to tax the million-pound profit of the Rokhana Copper interests, even though the meteoric rise in

their profit was the direct outcome of rearmament, which drove up the price of copper to an unnaturally high level.

(4) Selfish Attitude of Wealthy Classes

In order to create a moral basis for the "Rich Men's Revolt" it was argued that while the companies themselves might be rich, their shareholders, who would ultimately have to bear the burden of the new tax, belonged largely to the category of small investors, who could ill afford to do without the full extra dividend. As is usual in such cases, poor destitute widows wrote letters to Editors complaining that they would be condemned to misery and starvation if a heartless Chancellor of the Exchequer were to insist on the tax leading to the reduction of the dividend on their speculative shares from 150 to 120 per cent. Few readers of those heart-rending letters knew that there exists an agency near Knightsbridge which, besides supplying various domestic employees, respectable-looking guests in immaculate evening dress to make a fourteenth at dinner parties or a fourth at bridge parties, etc., is also well equipped to supply destitute widows at short notice.

The spectacle was not exactly edifying. The British wealthy classes failed to live up to their traditional reputation for being ready to make sacrifices for the good of the country. The whole early history of British Parliament consists of a series of examples of the Conservative rich taxing themselves through their representatives at Westminster. On the present occasion, however, intoxicated by the growing profits after a number of lean years, and demoralised to a degree by the symptoms of a boom which were beginning to manifest themselves, the wealthy classes wanted someone else to bear the burden of the rearmament from which they derived, directly or indirectly, such handsome profits. They did not mind who it was so long as it was not themselves. Let indirect taxes be raised, if necessary, since the bulk of the burden would thus be thrown on the working classes. Let the income tax be raised, if it was inevitable, since the bulk of the burden would thus be borne by the middle classes. They would agree to anything provided that their excess profits remained immune.

to understand was that their revolt should receive the unexpected support of the predominant majority of the Labour party. Those who had been loudest in denouncing Mr. Chamberlain for being the patron-saint of rearmament profiteers were the first to attack his attempt to make the rearmament profiteers pay something towards the cost of rearmament. The National Defence Contribution scheme was so obviously in accordance with the interests of the working classes that it was astonishing that a party claiming to represent those classes should fail to give it whole-hearted support, irrespective of the fact that it had been put forward by their opponents. Admittedly, it must have been annoying for them to see a Conservative Chancellor of the Exchequer and prospective Prime Minister steal their thunder and carry out exactly the ideas which they themselves had advocated. Nevertheless, there was no justification for them to repudiate their principles by trying to make political capital out of the unpopularity of the proposed tax. Even from the narrowest possible point of view of party politics, it would have been to their interest to support Mr. Chamberlain in the matter of the National Defence Contribution, if only to embarrass his followers who were attacking him. The Labour Party could easily have created the farcical situation of a Prime Minister being upheld by the Opposition in face of the violent attacks of members of his own party. They might even have brought about a split between the reactionary and progressive elements of the Conservative party. But the petty politicians of the Labour party thought that the Opposition's only task was to oppose. Mr. Chamberlain was in favour of a measure. This was sufficient reason for them to attack it, even though they had to do so in the rather compromising company of armament profiteers and their spokesmen.

(6) Principles *v.* Details

And what were the "taxing-ourselves-to-the-bone" economists doing all this time? Surely they, if nobody else, must have come out in full strength to support Mr. Chamberlain's National Defence Contribution scheme? After all, it was based on their suggestion of financing rearmament as far as possible out of taxation. Not a word was heard from that camp in favour of the proposal. Their silence during the period of the National Defence Contribution controversy was very eloquent indeed. It may have been due to the fact that while they were in favour of heavy taxation they disapproved

of the particular type of tax adopted by Mr. Chamberlain. But if this was so, why did they not say so? They could still have supported Mr. Chamberlain on general grounds without necessarily approving all the details of the scheme, or even its general outlines. If they had only restated their point of view in general terms, it would have been some help. No support of any sort, however, was forthcoming from this quarter. In fact, some of the members of the "taxing-our-selves-to-the-bone" school actually came out against the National Defence Contribution.

Admittedly, the details of the scheme left much to be desired, but then Mr. Chamberlain made it plain from the very outset that he was open to suggestions for improving the scheme. Obviously what he aimed at was not so much to levy a heavy tax on the direct or indirect armament profits of the past fiscal year but to create an apparatus by means of which he would be able to check wholesale rearmament profiteering when that movement had assumed a thoroughly inflationary character. It was largely thanks to the Excess Profit Duty that inflation was kept down in Great Britain during the war to a much larger extent than in any other European belligerent country. Even though at the present stage rearmament finance bears no comparison with war finance during the years 1914–18, the difference is merely one of degree. It is by no means unreasonable to fear that, should the danger of aggression become more acute, the pace of rearmament would have to be accelerated and heavy inflation might become inevitable. For that contingency the existence of some such tax as Mr. Chamberlain's original National Defence Contribution would have been invaluable. It was this consideration more than any desire for an immediate substantial increase of taxation revenue that was probably responsible for the origin of the National Defence Contribution scheme.

(7) Machiavellian Motives?

There are various other explanations. It is suggested in Opposition circles that Mr. Chamberlain was aware from the very outset that his scheme would not go through, and that he introduced it and persisted with it for weeks merely in order to prove that he was not the reactionary Tory and supporter of rearmament profiteering he was made out to be. This theory attributes a great deal more Machiavellianism to Mr. Chamberlain than he probably possesses, although he had ample opportunity to learn from Mr. Baldwin. Possibly Mr

Chamberlain, too, has a Machiavellian mind hidden under the disguise of a plain citizen from the Midlands. Nevertheless, even if the above theory is correct, the Socialist politicians had all the more reason to blame themselves for having played so beautifully into Mr. Chamberlain's hand.

There was yet another theory, according to which the whole scheme was the work of the two senior Permanent Officials of the Treasury, Sir Warren Fisher and Sir Richard Hopkins. They both came originally from the Inland Revenue Department, and were therefore eminently qualified to work out new taxes. As is well known, the Inland Revenue Department shares with the Roman Catholic Church the distinction of being the most efficient organisation in the world. In recent years the two principal totalitarian States have also made a bid for this distinction, but their efficiency has yet to stand the test of experience. Possessing an essentially efficient weapon, the permanent heads of the Treasury who had graduated from the Inland Revenue Department were naturally tempted to make use of it, just as Germany's leaders before 1914 were tempted to make use of the highly efficient organization of the Prussian army. It is thus conceivable that Sir Warren Fisher and Sir Richard Hopkins were subconsciously influenced by their desire to give the Inland Revenue department a fair chance to show its true efficiency outside the routine work of well-established taxation. This theory does not, however, sound very convincing, for the simple reason that it is by no means easy to persuade Mr. Chamberlain to take up new ideas unless he is thoroughly satisfied that he wants them. The suggestion may have come from the two senior officials, but it must have appealed to Mr. Chamberlain himself, as is shown by his reluctance to drop it.

(8) National Defence Contribution Scheme Abandoned

Under the frontal attacks of the Opposition and of the various organisations representing the interests affected by the new tax, and stabbed in the back by his own supporters, Mr. Chamberlain had no choice but to abandon his scheme and replace it by a Corporation Profits Tax, which, though retaining the name of National Defence Contribution, was not primarily aimed at taxing the additional profits earned as a direct or indirect consequence of rearmament. Since the original scheme is dead and buried, there would be no object in examining in detail the bewildering array of arguments against it. In so far as they were justified, the errors they were

directed against could have been rectified by modifications of detail without killing the principle.

In reality there was only one valid argument which could have been, but in fact was not, directed against the National Defence Contribution scheme as a whole. The fundamental mistake of the scheme was that it came at the wrong moment. Its main justification lay in the fact that it was meant to check the boom in equities and thereby counteract the transfer of funds from the gilt-edged market to the industrial market. This was essential in the interest of financing rearmament. We saw in the last chapter the difficulties which the gilt-edged market had to contend with. Had the boom continued, the temptation of a higher yield and capital appreciation offered by industrial shares would have led to persistent selling of Government loans by investors, and the result would have been a further heavy slump in the gilt-edged market. How in such circumstances the Government could have issued additional hundreds of millions of pounds of loans even at ruinous interest rates is difficult to visualise. The fact that the original National Defence Contribution scheme was meant to obviate the development of such a state of affairs outweighs all the arguments against the scheme. By April 1937 there was, however, no longer any need for a drastic remedy against the effects of a boom upon Government borrowing, for by that time the gold scare had effectively checked the boom. Needless to say the National Defence Contribution was elaborated long before the beginning of the gold scare, and in any case it was impossible to foresee in April the full extent of the effect of the gold scare. By jobbing backward, it is easy to criticise the Treasury for having brought out its National Defence Contribution scheme during the gold scare. Had it been brought out a year earlier, it would not have done much damage. Had it been brought out after the effects of the gold scare had worn off, its harmful effects upon the stock market would have been comparatively moderate. As it was, the existence of the gold scare and the announcement of the National Defence Contribution scheme resulted between them in a heavy slump in the London Stock Exchange, with considerable repercussions on Stock Exchanges abroad. Even so, the main cause of the trouble was the gold scare, which could have done quite enough mischief even in the absence of the National Defence Contribution, while the latter would have done relatively little harm in the absence of the gold scare.

CHAPTER XVIII

REARMAMENT AND THE FRANC

(1) National Defence *v.* Monetary Stability

Although in dealing with the depreciation of the franc in Part III of this book we made casual reference to the rôle played by rearmament, the importance of that factor makes it worth while to examine this aspect of the depreciation of the franc in closer detail. There can be no doubt that but for the necessity of extraordinary expenditure on rearmament, the Governments of MM. Blum and Chautemps would have put up a much stronger resistance to the depreciation of the franc, and would have stood a better chance of succeeding in postponing, if not actually avoiding, that depreciation.

It is an irony of fate that while the Conservative Government of M. Laval and the semi-Conservative Government of M. Sarraut readily sacrificed the interests of national defence in order to prolong the defence of the franc, the Socialist Government of M. Blum and the Radical-Socialist Government of M. Chautemps placed the interests of national defence and security above financial considerations. It is true, as the example of Germany and, to a less extent, Italy, has shown, that the policy of maintaining the stability of the currency is not necessarily incompatible with a policy of vast expenditure on rearmament. The difference between those two countries on the one hand and France on the other is that while the former are authoritarian States, France is a liberal, democratic State. In an authoritarian State it is possible to defend the currency at an overvalued level without necessarily undergoing the adverse effects witnessed in France owing to the prolonged defence of the franc. Germany was in a position to maintain the reichsmark and at the same time minimise the extent of the rise in her price level brought about by the rearmament which she carried out on a gigantic scale. She was also able to defend her exchange against an outflow of capital which, in a liberal State, would inevitably accompany the overvaluation of the currency.

(2) France Sacrificed Security for the Sake of Defending the Franc

Apparently the defence of a currency at an overvalued level is a luxury which only authoritarian States can indulge in. If a democratic State such as Great Britain or France attempts to follow the same course, the price is paid in the form of a deterioration, absolute or relative, of the strength of national defence. It was because of the overvaluation of sterling between 1925 and 1931 that the strength of British national defences declined to danger-point, and it was because of the prolonged defence of the franc at an overvalued level between 1931 and 1936 that French national defence failed to keep pace with the strides made in German rearmament after the advent of the National Socialist régime. In 1933 the armed strength of France was a multiple of that of Germany. The superiority of Air Force, gun power and mechanised devices more than made up for the inferiority of French man-power compared with German man-power. All that France would have had to do was to keep up this superiority, and her security would not have been menaced. When from 1933 onward Germany began to increase her armed strength, it was vital that France should keep pace with her in the rearmament race. Thanks to her stronger financial position, she would have been able to do so but for the self-imposed handicap of the overvalued franc.

From 1934 onward the French Governments that succeeded one another embarked upon futile efforts to balance the budget, and to that end they kept the armed forces on short rations. They did not actually dare to make any drastic cuts in national defence expenditure, but they certainly did not allocate to the defence forces the amounts required in order to keep pace with German rearmament. In face of the parsimony of Finance Ministers, the General Staff had to watch, helpless, as the superiority of French armed strength over German armed strength gradually disappeared. While across the Rhine the Government was spending untold milliards, created out of nothing, to increase the striking power of the army, the French Government was sitting on its dwindling gold reserves and refused to heed the urgent entreaties of its General Staff for larger expenditure.

By 1936 Germany had actually assumed the lead in armed strength on the Continent. The dream of French hegemony for the sake of maintaining peace had vanished.

The security of France was sacrificed to the prolonged defence of the franc at an overvalued level, not only through the Government's refusal to keep pace with German rearmament but also through the loss of several valued allies. Poland, Yugoslavia and Roumania, armed to the teeth thanks to French loans and credits obtained in earlier years, equipped mainly with French war material, one by one deserted their French allies, partly because the latter, preoccupied with the death-struggle of the franc, could ill afford to continue to subsidise them adequately with loans, and partly because they realised the change in the balance of power. Even though Germany was not in a position to assist them financially, the rise of her relative military strength and the unwillingness of France to compete with her gave these countries something to think about. They came to the conclusion that in the circumstances it was not safe to be on the French side. While it would be going too far to suggest that they actually became Germany's allies, they could no longer be relied upon by France as a force tending to divert part of Germany's striking power from the Rhine.

(3) M. Blum increases Arms Expenditure

By the time France realised the necessity of taking up the German challenge in the rearmament race, it was too late. All that France could do was to endeavour to prevent a further increase of Germany's armed superiority. It was M. Blum, often described as an internationalist and an alien intellectual, who realised the dangerous position into which France had drifted under her so-called patriotic Governments. From the moment of his advent to office he spared no effort to make up for lost time. He materially increased budgetary allocations for national defence.

Conceivably, internal political considerations were partly responsible for this attitude. On his advent he was regarded by the General Staff with the natural distrust of the professional soldier towards the Socialist politician with a reputation for being an internationalist and a pacifist. While the army had submitted without a murmur to the short-sighted economies of M. Laval, it is highly doubtful whether it would have put up with a similar policy on the part of M. Blum. The example of General Franco was tempting and the Socialist excesses during the first months of M. Blum's régime certainly provided ample provocation. It was of vital importance for M. Blum, and indeed for the Socialist régime, that the Govern-

ment should establish friendly relations with the General Staff. Short of discarding all its Socialist principles, the only way to that end was to open the purse-strings to satisfy the financial requirements of national defence. The generosity with which M. Blum met the General Staff's demands for increased national defence expenditure was in sharp contrast with the rigid economies of his predecessors in this sphere. Indeed, a few months after his advent M. Blum had succeeded in establishing friendly relations with the French General Staff, and General Gamelin is said to have remarked that he could get on much better with M. Blum than with any of his predecessors.

But apart altogether from internal political considerations, the international political situation itself provided ample reason for M. Blum to speed up rearmament. As a result of the Spanish Civil War there was an acute danger of European complications, and it was vital for France to be prepared. The Franco–Italian frontier, from which the French divisions had been removed at the end of 1934 as a result of the rapprochement between the two countries, had to be manned again as before. It became urgent to prolong the Maginot line of fortifications along the Belgian and Swiss frontiers. It became necessary to reckon with the possibility of a hostile southern neighbour as a result of a victory by General Franco with German and Italian aid. In face of this situation, there was no choice but to rearm, irrespective of costs.

(4) Devaluation and Rearmament

Owing to the growing national defence expenditure, in addition to the increase of expenditure through social legislation, public works, etc., M. Blum had no alternative but to submit to the inevitable and devalue the franc. His opponents often argued that but for the advent of the Socialist Government it might have been possible to continue to defend the franc, and devaluation might have been avoided altogether. If this contention were justified—which it certainly is not—France would have to thank her lucky stars for the advent of M. Blum's Socialist Government. The rigid defence of the franc would have prevented rearmament, and the inferiority of French armed strength compared with German armed strength would have assumed more and more alarming proportions.

Had the devaluation been carried out satisfactorily, it would have enabled France to go ahead at full speed with her rearma-

ment programme. As it was, a few months after the devaluation, the franc once more became overvalued. What was worse, owing to its inadequate extent the devaluation failed to reduce the burden of the excessive public debt to any noteworthy degree. In the circumstances, by the beginning of 1937 M. Blum found himself confronted with the same dilemma which his predecessors had had to face. From the point of view of national defence it became increasingly important to spend more and more. From the point of view of the defence of the franc at its new level, however, it was essential to keep down expenditure.

Confronted with this choice, M. Blum was inclined to fall into the error of his predecessors. In his statement on March 6, in which he promised to mend his ways and pursue a more orthodox budgetary, monetary and social policy, he also made vague references to keeping down national defence expenditure. Once more the security of France was being sacrificed for the sake of preventing a heavy depreciation of the franc. Even though the principle that the exceptional expenditure on national defence should be segregated from the ordinary budget and that no attempt should be made to balance it out of current revenue was admitted, nevertheless the demands of the General Staff for more expenditure were no longer treated with the same generosity as before.

(5) M. Chautemps and National Defence Finance

Nor was there any material change in this respect after the advent of the Chautemps Government. Although the rigid defence of the franc was abandoned, efforts to reduce the deficit were increased. M. Chautemps was not under the same obligation to please the General Staff as his Socialist predecessor had been, and could afford to say "No" if demands for additional expenditure were presented.

In one respect the Government yielded to the urgent and insistent representations made by the General Staff. The drain on the gold reserve which had been almost continuous since 1934 was brought to an end in September 1937. It was decided to let the franc depreciate rather than defend it at the cost of further depleting the Bank of France's gold stock. That gold stock came to be regarded as an indispensable war chest, which could not be frittered away in a futile defence of the franc. From this point of view the wisdom of the Chautemps Government compared with the folly of its predecessors is evident. It was, however, premature to rejoice

over the adoption of this sensible course. After a series of depreciations, the franc settled in October in the vicinity of 147 to the pound. In January 1938, however, it once more became shaky, and the Government had to support it at that level. By February, it had become necessary to withdraw from the Bank of France the 3 milliard francs of gold which had been ceded to the Central Bank by the Exchange Stabilisation Fund in November 1937.

CHAPTER XIX

DR. SCHACHT'S CONJURING TRICKS

(1) "COLLAPSE" PREDICTIONS FAIL TO MATERIALISE

WHEN the National Socialist régime, soon after its advent to power, began to spend lavishly on public works, and to an even larger degree on rearmament, experts all over the world predicted that this policy of extravagance was bound to lead to an early collapse in Germany. Exactly what they meant by "collapse" they never specified—whether they meant a complete default on external debts, a default on internal debts, a repetition of the inflation of 1923, or a recurrence of the banking crisis of 1931. They merely predicted collapse, and left it at that. This expert opinion was to a large degree accepted by the public and by official quarters abroad. The result was that the countries whose security was beginning to be menaced by German rearmament allowed the process to continue unhampered at a time when they were still in a position to check it by firm action with a minimum risk of war. "Why risk a conflict, even if its result is certain to be in our favour? We only have to wait and Germany will collapse in any case in a year or two."

This faith in the coming collapse in Germany was one of the main considerations which prevented the French Government and other Governments concerned from taking firm action in 1933 and 1934, even though they would have been able at that time to compel Germany to abandon her menacing preparations. At that stage Germany could not possibly have afforded to risk war. The fact that in the summer of 1934 the concentration of a few mechanised Italian divisions south of the Brenner was sufficient to frighten Hitler into abandoning his Austrian associates to their fate speaks for itself. If only France had put her foot down at that time, German rearmament might have been checked. Although there were several reasons why France chose to let things slide—among others, her preoccupation with the budgetary position and the fate of the franc—the belief in the hand of Providence, in the form of a German collapse—whatever that may have

meant—was certainly one of the reasons for her passive attitude in face of the growing German peril.

Five years have passed since the advent of the Hitler régime, and the much-predicted collapse has failed so far to materialise. It is true that Germany virtually suspended the service of her long-term external indebtedness, but that could hardly be called a collapse from the German point of view. For the rest, economic and financial developments in Germany have proceeded much more smoothly than even the most optimistic of Nazis could have anticipated. Far from collapsing, Germany has recovered from the effects of the crisis of 1931, and this in spite of the fact—or perhaps because of the fact—that she has been spending milliards on rearmament.

(2) "Miracle" of Rearmament Finance

Had anybody dared to predict five years ago that within the next five years Germany would be able to spend so many milliards on rearmament, he would have run the risk of being certified as insane. In face of the unquestionable evidence that those milliards have actually been produced out of nothing, the experts who yesterday predicted collapse are now talking about the "inexplicable" miracle performed by that superman, Dr. Schacht. Although they still continue vaguely to predict collapse at an unspecified date in the more distant future as a result of the disastrous growth of the public debt, it is now evident that no collapse which would materially reduce the extent of the German menace is likely to occur. The politicians who were misled by the cocksureness of the experts about Germany's coming collapse have realised by now that they were following false prophets. They no longer rely upon the imminent collapse as a convenient way out of their difficulties. Unfortunately the belated realisation of the truth is of little practical use. In the meantime, as a result of their credulity, Germany has been allowed to grow too strong, and no Government would at present think of doing what could safely have been done several years ago to stop her aggressive designs.

Viewed from an orthodox angle, what has happened in Germany during the last five years may well appear little short of a miracle. We all know that inflation in 1923 virtually wiped out German savings. Although there was some accumulation between 1923 and 1931, most of it was destroyed by the crisis and the prolonged depression, so that in 1933 the volume of capital available for financing Government expenditure in

excess of current revenue was negligible. And yet under the expert guidance of Dr. Schacht, Germany was able to produce milliard after milliard for rearmament, just as a conjuror is able to produce rabbits out of an apparently empty top-hat. This in itself was, however, no miracle, and but for the shortness of human memory we should all remember that the same thing happened to a much larger extent during the war. In 1914 it appeared to most experts that a modern war would be too expensive to last for more than a few months, since no country could afford to finance it for longer. Had the last war been financed out of the savings that existed in 1914, it would certainly have come to an end before the close of that year. What happened, however, was that war expenditure by Governments created fictitious capital, which became available either to be taken in taxation, as was done largely in Great Britain, or to be re-borrowed, as was done largely in Germany. The amount spent during the war by most belligerent countries was several times larger than the total financial savings of their nationals on the eve of the war. If it can be done in time of war, there is no reason why it should not be possible in time of peace.

(3) No Inflation

What is less easily understandable from an orthodox point of view is how it was possible, notwithstanding the gigantic expenditure undertaken during the last five years, to avoid inflation on a large scale. After all, during the war the process of recovering the amount spent, whether in the form of taxation or in the form of loans, was nowhere watertight. Everywhere it was accompanied by monetary inflation, in addition to profit inflation and income inflation, all making for an inflationary rise in commodity prices. This was because, notwithstanding the series of restrictive measures—mostly belated and inadequate—employed by the Governments, the financial system of the belligerent countries remained to a large extent free. There was no real, all-round effort to prevent a rise in the cost of living, nor much effort to prevent the rising trend of wages. As for profits, they were allowed to soar sky-high. It was said that under the individualist system the possibility of making bigger and bigger profits was the best inducement to obtain a higher degree of efficiency, which was, after all, vital for speeding up the production of war material. Apart from some mild moral pressure, subscription to War Loans was nowhere compulsory, and Governments

which were unable to cover their deficit by such means had to resort to the printing press.

(4) "Magic Coin" spent Over and Over Again

Under the authoritarian system, especially in Germany, it was possible to avoid the inflationary consequences of large-scale expenditure on rearmament. No sooner was money spent than it was mopped up again in some form or another. Government contractors were not paid in cash but in promissory notes, euphemistically called *Arbeitsbeschaffungswechsel* (employment-creating bills). They were not marketable, though to some extent they were discounted by banks or accepted as collaterals to advances. After some considerable delay they were consolidated into long-term loans, subscription to which by banks, insurance companies, savings banks and large industrial and commercial companies with liquid resources was compulsory. At an early stage a law was passed limiting dividends to between 6 and 8 per cent. Any profit in excess of that percentage had to be reinvested in Government securities. And since the bulk of the amounts paid out in wages or dividends found their way sooner or later to savings banks, banks or insurance companies, the commandeering of the resources of these institutions completed the watertight financial system by which it became possible to spend the magic coin over and over again. There was no need for the Government to resort to the printing press, even though the note circulation had to be increased as a result of the natural demand brought about by the expansion of trade. Wages were kept down as far as possible, and so were cost of living and cost of production, although in this respect the system was not nearly so watertight as in respect of the recovery of the amounts spent. The degree of actual inflation was moderate. It bore no proportion to the degree of expenditure on rearmament.

(5) Discipline and Stability

To achieve this was no miracle. It cannot even be credited to Dr. Schacht's genius, although he rendered invaluable service to the National Socialist régime by lending his name and his efficiency to secure the execution of a policy of which he disapproved and in which he did not believe. The prevention of inflation was due to the high degree of discipline forced upon the economic system, which was subject to more rigid and efficient restrictions and regimentations than in any country during the war.

Admittedly, it would have been impossible to enforce discipline but for the confidence of the public in political and financial stability. In the latter respect, Dr. Schacht's presence at the helm was very useful to the National Socialist Government, since he was regarded as the saviour of the mark in 1923 and his name inspired immense confidence among the German public. After all, it was his advent which led to the emergence of Germany from the desperate chaos of 1923. It was his departure in 1930 which was soon followed by a relapse into crisis and chaos. No wonder it was felt that so long as he was in charge of the monetary policy of the Reich, there was no danger of another currency slump.

(6) Increase of Public Debt

Indubitably, the German public debt has increased to an amazing degree—no one knows quite to what degree—since 1933. On the other hand, simultaneously with the deterioration of the financial position of the Government there was an improvement of the financial position of banks and commercial and industrial companies. The profits earned on rearmament thawed the frozen credits, enabling the banks to recover their pre-crisis liquidity. The increase in the floating debt was at first alarming, but consolidation has made considerable progress during the last two years. At first the consolidation was purely compulsory, but subsequently the accumulation of savings brought about by Government expenditure resulted in a growing liquidity in the German capital market, and there developed a certain amount of genuine demand for the various funding loans issued by the Government.

It is true that even at this stage the over-subscription of these loans was largely artificial. A well-known German financial journalist, high in favour with the National Socialist régime, had a narrow escape from being sent to a concentration camp because he published the exact extent of the over-subscription of a loan before it was actually issued. There can be no doubt, however, that conditions of liquidity in the German money market and capital market have improved materially in recent years. Admittedly, in the case of banks all that happened originally was that frozen commercial bills were replaced by equally frozen Government bills. Gradually, however, those bills have come to be regarded as being much less frozen, since the bonds into which they were eventually converted became marketable to some degree.

(7) Export Subsidies

So much for the internal aspects of rearmament finance in National Socialist Germany. Its international aspects presented a much more difficult problem. They would have been impossible to solve but for the watertight system of exchange control by which Germany has surrounded herself. Although there is still some leakage, notwithstanding the death penalty for currency smuggling, a flight of capital on a large scale such as has been experienced in France in recent years is out of the question. The only danger for Germany was a deterioration of the trade balance as a result of rearmament. That danger was very real indeed. Rearmament necessitated unusually heavy raw material imports. At the same time, since German industries were fully occupied by carrying out Government contracts, they concentrated less upon maintaining their markets abroad. Moreover, although the rise in the cost of production was kept down by the control of wages, prices and the cost of living, it was sufficient to handicap German exporters. But for the vigorous and manifold intervention of the Government in the sphere of foreign trade, Germany would eventually have had to cut down her imports, including those for rearmament, owing to the impossibility of paying for them by means of exports.

It is especially in this respect that Dr. Schacht's subtle genius was indispensable for the success of the National Socialist rearmament scheme. It was necessary to continue to import, and, to that end, to maintain exports in spite of the fact that owing to their higher cost and the deterioration of their quality, German goods were no longer competitive in many foreign markets. To a large extent this was achieved by means of subsidies to exporters. Notwithstanding the deterioration of the quality of German manufactures through the use of substitute materials and through the haste with which they were produced, it was possible to find buyers abroad, provided that the price quoted was low enough. To that end, subsidies amounting to 30, 40 and even 50 per cent and more were granted. Although in the long run it hardly paid to buy the German goods, even at their lower cost—especially capital goods such as factory equipment—the temptation of the low price was in many instances too strong to resist.

(8) Skilful Manipulation of Clearing Agreements

This policy in itself would not have been sufficient to save German exports from contracting sharply. It was supplemented by a series of exchange clearing agreements which were manipulated by Dr. Schacht with supreme skill. He fully realised that amidst existing conditions debtors were in a strong position in relation to their creditors. For this reason he did not attempt to push German exports by granting favourable credit terms, as had been done in the past. In fact, the huge credits granted to Russia prior to the advent of the National Socialist régime were liquidated. What Dr. Schacht aimed at was to become a debtor to the countries to which he wanted to sell German goods. This end was easily achieved through the working of exchange clearing agreements. For instance, Dr. Schacht placed the Greek Government under a heavy debt of gratitude by buying up the whole of the frozen tobacco stock of the country. It was only later that the Greek Government realised the trap into which it had fallen. As a result of the huge tobacco export to Germany, huge frozen clearing balances were created. There was no other way for its liquidation than an increase of purchases of German goods. Accordingly, permits for imports from other countries were withheld, so as to compel Greek firms to import from Germany even if the German goods were worse and more expensive. There was no longer any need for Dr. Schacht to subsidise German exports to Greece, since Greece was obliged to buy German goods if she wanted to be paid for her tobacco exports. The same method was applied in regard to Yugoslavia, Roumania, Turkey and other countries.

To a large extent Germany was able to cover her food and raw-material requirements without having to pay cash for them, and the victims of this method simply had to accept German goods in payment, the alternative being no payment at all. The same system did not, however, work in every direction, since Germany had no clearing agreements with a number of countries. In order to be able to import raw materials from those countries, Germany resold part of the goods bought from the countries with which she had clearing agreements. Thus Turkey found it increasingly difficult to export raisins because of the competition of German sales of Turkish raisins. Not having had to pay cash for them, the Germans could afford to undersell the Turkish exporters, who

thus found that their only salvation lay in inducing Germany to buy more and more raisins, as a result of which Turkey had to import more and more German goods.

It was some time before the various Governments realised how they had been tricked. For a long time Dr. Schacht was able to pursue his method without any difficulty. In fact, since during the depression every country was anxious to sell, he was hailed as a benefactor who had relieved them of their surplus stocks. When in 1935 Dr. Schacht paid a visit to the capitals of South-Eastern Europe, his tour resembled a triumphal march. He was given an enthusiastic welcome everywhere, and high decorations were bestowed upon him by grateful Governments.

(9) Debtors' Strong Position

Sooner or later, however, the Governments became aware of the disadvantages of the German method. By that time, the amount of the frozen clearing balances to the debit of Germany was in every instance much more than they could afford to lose. Thus when they started to check imports to Germany in order not to increase further the frozen balances, the German authorities were in a position to bring pressure to bear upon them by threatening to restrict the goods exports necessary for the liquidation of the debit balances. It became necessary to come to terms with Dr. Schacht for the gradual and very slow liquidation of the frozen surplus, in return for which the creditor countries had to agree to maintain a high volume of current exports against the import of German goods.

The result of the skilful manipulation of clearing agreements by Dr. Schacht was a high degree of German politico-economic penetration in Central and South-Eastern Europe. This was highly detrimental to Franco-British interests from both a political and an economic point of view. It would have been easy to counteract the growing German influence by applying weapons similar to those of Dr. Schacht, or at any rate by defending the interests of British trade through the timely establishment of exchange clearing agreements with the countries concerned. Instead, Dr. Schacht was allowed to carry out his policy undisturbed, and since the Yugoslav importer was able to sell his goods in Great Britain against free sterling, the Yugoslav Government saw no reason to prevent the transfer of Yugoslav purchases from Great Britain to Germany.

(10) Exchange Clearing and Rearmament

When the various South-Eastern European and South American Governments joined in the international rearmament race, this provided Dr. Schacht with an opportunity to apply a new method of securing advantages for Germany. Since the armament industries of most countries were fully engaged in carrying out rearmament orders for their own Governments, it would have been by no means easy for countries without such industries to rearm fast enough, even if they had possessed the financial resources required, which was not the case. Their Governments therefore welcomed the German scheme by which they were able to obtain German war material without having to pay cash for it. It is true that the war material was not altogether new. As a result of the experience gained in Spain, the German High Command decided to discard certain kinds of weapon and replace them by better types. Dr. Schacht was able to unload his second-hand war material on countries such as Greece and Chile, which were only too glad to buy it so long as they did not have to pay cash for it. The transactions were arranged through clearing or compensation agreements, and Germany was once more able to increase her foods and raw material imports from the countries which purchased her discarded war material.

By this method Dr. Schacht killed several birds with one stone. He enabled the Reichswehr to discard without hesitation any war material as soon as something better was invented. In this respect the Reichswehr was therefore in a much more favourable position than the armed forces of its potential opponents. He enabled Germany to import much-needed food and raw materials without having to part with exchange in payment for it. Last but not least, he secured for Germany political influence in the countries which took over the German war material. After all, it is useless to buy German guns unless the continuity of the supply of ammunition, spare parts and replacement units is also secured. To that end, it is essential to be politically on friendly terms with Germany. In case of a war in which the purchaser of German war materials found himself among Germany's opponents, his war material would soon become practically valueless owing to the impossibility of replacement. This may in given circumstances be a weighty enough argument to induce a hesitating Government to make up its mind which group of powers to join.

Let it be far from me to blame Dr. Schacht for the application of these methods. After all, he is a German, and as such he has to do his best for his country. If anyone deserves criticism, it is Central Bankers, Treasury officials and politicians in the democratic countries, for having allowed Dr. Schacht's triumphal march to proceed unhampered until it became almost too late to check the growth of German influence. Dogmatic opposition to the adoption of exchange clearing in this country and, to a less extent, in France, was largely responsible for the success of German penetration in Central and South-Eastern Europe.

(11) Food Shortage

Admittedly, notwithstanding the efficiency of the German economic system and Dr. Schacht's subtle genius, there is evidence of a growing shortage in certain foodstuffs ; but then this is in accordance with General Goering's declared " guns instead of butter " policy. The extent of raw-material imports for rearmament has been so large that it has been quite impossible to provide enough foreign exchange to meet food-import requirements in full. Reports about food shortage in Germany should not, however, be exaggerated. Visitors whose experience is confined to residence in luxury hotels usually come back with stories about the restrictions imposed upon the use and preparation of food even in these high-class establishments, drawing the conclusion that " if even the A—— Hotel is instructed to save the fat left over when the bacon is cooked, it is easy to imagine what misery must exist among the poorer classes." As a matter of fact, the reduction of unemployment from six million to half a million must have increased quite considerably the consuming capacity of the poorer classes, and even though they may find it difficult to buy certain foodstuffs, the total food consumption of the whole German people must now be at least as high as it was in 1933. This fact should be borne in mind by those who expect a collapse of the National Socialist régime as a result of a food shortage, and also by those who, in the name of humanity, demand that Germany be given colonies and credit in order that her nationals may be fed decently. To the extent to which food shortage does prevail, the remedy lies entirely in the hands of Germany. The moment she decides to import less for rearmament, she will be able to feed her people better.

CHAPTER XX

REARMAMENT AND THE LIRA

(1) The Pesaro Statement

Ever since 1926 Italian trade has been suffering under the handicap of an overvalued lira. Signor Mussolini's ambition was to stabilise the lira at a higher level than the franc, and, the level once chosen, he stuck to it with a grim determination worthy of a better cause. His statement made at Pesaro in August 1926, that he was prepared to defend the lira to the last drop of his blood, has become a byword. Like so many other bywords, it has been responsible for immense harm, to Italy and to the rest of mankind.

Owing to the deliberate overvaluation of the lira, Italy did not share in the wave of prosperity which the world enjoyed until 1929. While during that period trade was booming in other countries, there was acute depression in Italy; there were a number of bank difficulties and failures among first-class firms. During the depression and the financial crisis, Italy was caught in the vicious circle of deflation. Greater and greater sacrifices were demanded from her people for the sake of defending the lira. Unemployment was increasing, and the Government had to support virtually all banks and most leading industrial combines.

(2) Flight from the Lira

In the course of 1934 an acute flight of capital set in, rapidly depleting the gold reserve of the Bank of Italy. Notwithstanding drastic deflationary measures, it was impossible to restore the international equilibrium of the lira. The problem of the import surplus and the budgetary deficit gave rise to growing concern. The obvious way out was to devalue the lira, but at that stage Signor Mussolini was not prepared to go back on the promise he had made at Pesaro eight years earlier. And since the growing depression that accompanied the hopeless struggle of the lira endangered the popularity of the régime, he decided to embark upon the Abyssinian adven-

ture largely in order to divert attention from internal economic and financial difficulties.

From the beginning of 1935 the lira was allowed to depreciate gradually, though to a moderate extent only. Privately owned foreign assets were called in, and provided the foreign exchange stock required for the financing of external purchases in connection with the Abyssinian war and sanctions. Owing to the speedy termination of the war, Italy succeeded in retaining the greater part of her gold reserve and, in addition, some of the marketable foreign assets. The lira remained overvalued, and even after the removal of sanctions Italian exporters had to rely upon subsidies.

This was the situation when, in September 1936, France and the other Gold Bloc countries devalued their currencies. After some hesitation Signor Mussolini decided to follow their example. In October 1936 the lira was "adjusted" to its former parity in relation to sterling and the dollar. Anyone who had dared to suggest that the operation amounted to devaluation would probably have found himself on the Lipari islands. Signor Mussolini was about two years too late in making up his mind to do the inevitable. Had he devalued the lira in 1934 world history might have taken a different course. He would not have added Abyssinia to the Italian colonial empire, but the Stresa front would have provided a perfect safeguard to Italy's security and to European peace.

(3) Inadequate Devaluation

As a result of the internal expansion that took place in connection with the Abyssinian war, sanctions, and rearmament in general, the Italian price level lost touch with the world level during 1935 and 1936, and it is doubtful whether the extent of the "adjustment" of the lira to the dollar was sufficient. Simultaneously with the devaluation, the Government caused the tourist lira to depreciate to a fairly substantial discount compared with the new lira. This was not exactly an ideal start for the new currency. It reminds one of the Postmaster General who, when inaugurating a new telephone exchange, connected the first wrong number. Nevertheless, since the greater part of Italian trade was based on exchange clearing and compensation agreements, the moderate overvaluation of the lira after its devaluation presented no acute difficulties at first.

In the course of the year or so following the devaluation the Italian situation deteriorated, however, to a considerable

degree. This was largely the result of the adventurous foreign policy embarked upon by Signor Mussolini. Intoxicated by his success in Abyssinia, he set himself and the Italian nation the task of re-creating the Roman Empire. To that end he sent an expeditionary force to support General Franco in Spain and concentrated a large mechanised army on the Libyan-Egyptian border. Various Italian and Spanish islands and ports were converted into naval bases bristling with guns. Italian agents in Egypt, Palestine and French North Africa sought to arouse subversive anti-British and anti-French movements. Italian money and arms found their way to the troublesome tribes on the North-West Frontier of India, to agitators in Palestine, and to the pockets of Egyptian politicians. Money was no object when there was a chance to make trouble for the British and French Empires. Above all, rearmament proceeded unabated, swallowing many milliards of lire.

(4) Internal Financing Causes no Major Difficulty

Notwithstanding this orgy of expenditure, those who expected a financial collapse in Italy were as wrong as those who expected similar developments in Germany. As far as the internal aspects of Italian rearmament were concerned, they were by no means impossible of solution. After all, Italy is also an authoritarian State, even though she has no Dr. Schacht. In Italy, too, dividends were limited and excess earnings had to be reinvested in Government securities. As in Germany so in Italy, the Government is in a position to commandeer the funds of banks, savings banks and insurance companies, compelling these institutions to subscribe to new Government loans. When in the autumn of 1937 the budgetary problem became embarrassingly acute, the Government resorted to a 10 per cent capital levy. The story goes that when Signor Mussolini conceived his idea he consulted one of the few Italian financial experts who had the courage to hold independent views. The latter knew that it was useless to argue against the decision once it was made, but when Signor Mussolini asked what he could do next to raise the funds required, the expert replied: "You can repeat the same operation nine times."

As a result of the increased internal trade activity the Government was able to raise funds by unloading the banking and industrial shares it had had to take up during the lean years of the depression. In this respect its experience might well serve as a model for the Governments of democratic

countries, since it indicates the way in which Governments can moderate slump and boom on the Stock Exchange. By compelling banks to support their own shares and those of the industrial interests with which they were connected, and by subsequently relieving the banks of their holdings of shares, the Government prevented the depreciation from becoming accentuated through a disastrous Stock Exchange slump. When the tide turned and the growing profits through rearmament tended to give rise to a Stock Exchange boom in spite of the limitation of dividends, the Government, by unloading its holdings of industrial and banking shares, checked the unwanted movement. Had President Roosevelt adopted a similar policy in 1937, he might have obviated all the scares and jitters from which the United States and the rest of the world had to suffer.

(5) Deterioration of Exchange Position

From an internal point of view, the financing of Italian rearmament proceeded fairly smoothly. It was its external aspect that began to cause trouble in the course of 1937. Notwithstanding the removal of sanctions, and in spite of the efforts to increase Italian self-sufficiency, the exchange position became increasingly unfavourable. The deficit of visible trade increased considerably, largely as a result of the imports of raw materials for rearmament and, especially, the increased oil requirements of the Italian navy and air force in connection with the Spanish and Mediterranean activities. The export industries, too, were too busy with rearmament to concentrate attention on their markets abroad. To some extent the penetration of German trade in Central and South-Eastern Europe took place at the expense of Italy. It is true that the same weapons which were used so skilfully by Dr. Schacht were also at the disposal of Italy. She too had exchange clearing agreements with most countries in that part of the world. But she had no Dr. Schacht, even though it was suggested that the exchange of Signor Mussolini for Dr. Schacht for a period of six months would benefit both Italy and Germany.

Desperate efforts were made to compensate for the adverse visible trade balance by an increase of tourist traffic in Italy. In addition to the tourist lira, which had depreciated to more than 10 per cent discount against the official lira, foreign visitors were tempted to Italy by various devices of hotel coupons, petrol coupons, reductions in State Railway fares

amounting in some cases to 70 per cent, etc. Nevertheless, the competition of the devalued French and Swiss francs was too strong. Italy received a number of Central European tourists, from countries with which tourist expenditure was regulated through clearing agreements, but the spendings of tourists from whom the Italian authorities could have derived foreign exchange remained comparatively small. Owing to the political tension, relatively few British tourists visited Italy.

Nor were invisible exports from emigrants' remittances any more satisfactory. Owing to the political uncertainty and the uncertainty about the future of the lira, most Italians abroad confined their remittances to the bare minimum necessary for the current requirements of their relatives in Italy. It became evident that the bulk of emigrants' remittances in past years had represented not current items but capital items. Most Italian emigrants made it a rule to accumulate their savings in their native land. In existing circumstances, however, this is no longer done, and for this reason emigrants' remittances have fallen off considerably.

(6) Efforts to raise Funds Abroad

The Italian banks, acting upon official instructions, made desperate efforts to raise credits abroad. They succeeded in obtaining a certain amount in New York, but in most cases the credits were granted on the understanding that they would not be drawn upon to any large degree. In London, too, they received a number of credits, but the total amount obtained was small, because political relations between Great Britain and Italy were at the time highly unsatisfactory. Considering the fact that the credits raised were used if not actually for rearmament at any rate for strengthening Italy's food and raw material reserves in preparation for an Italo-British conflict, the attitude of some London banks was subject to criticism. The news of the granting of these credits inspired a writer in *The New Statesman* to the following epigram:

> Iscariot the Lord betrayed,
> Then wasted all the wages paid.
> Wiser to-day, he would have lent
> To Caiaphas at six per cent.
>
> He would have lost it just the same,
> But it's the *spirit* of the game.

As a matter of fact, the author of this epigram was hope-

lessly wrong in assuming that the London banks received 6 per cent on their credits. In point of fact the acceptance credits were arranged against a commission of $\frac{1}{8}$ per cent for three months. It was for the sake of this trifling amount, barely sufficient to cover the cost of the clerical work involved, that some London banks were prepared to risk their money, which would have been hopelessly lost in case of an Italo-British war. In all fairness it must be admitted, however, that the British authorities themselves were to blame for doing absolutely nothing to discourage the granting of these credits. Had a hint come from Whitehall, or from Bank of England, most banks would undoubtedly have refrained from granting credits. Official quarters, however, did not at first discourage the practice, and it was not until the *Financial News* launched a campaign against such credits that most clearing banks decided to cut them or, at any rate, to abstain from increasing them. Towards the end of 1937, however, a fresh attempt at inducing a group of acceptance houses to open new credits was frustrated by official veto.

(7) Liquidation of Foreign Assets

In the absence of extensive credit facilities, the Italian Government was compelled to leave no stone unturned to liquidate the foreign assets collected from its nationals. The bulk of these assets consisted of Italian dollar bonds issued in the United States before 1931 and repurchased subsequently by Italians. There was nothing to prevent the Government from reselling these bonds in Wall Street, except that the market was entirely unable to absorb any substantial amounts. The sale of a few thousand dollars' worth of bonds was sufficient to bring down their price by 4 or 5 points. In the course of 1937 an American financial group made an attempt to arrange the re-issue of these bonds in New York by offering them for public subscription. They were, however, informed in Washington that to do so would be contrary to the Johnson Act, by which no defaulter on war debts was allowed to issue loans in the United States. To some extent these assets and other foreign assets were used as security against credits abroad. For instance, a Swiss banking group granted a credit secured on the Italian participations in various Swiss subsidiary companies. In other instances the Italian Government used the assets in payment for imports from the countries concerned. For example, the Austrian securities surrendered by Italian nationals to their Government were sold to the Austrian

Government in part payment for Italian purchases of Austrian iron ore and other material. Thus, notwithstanding the Italian Government's desire to maintain its hold over Austria, these industrial participations were liquidated—a fact which indicated the extent to which the Italian Government needed foreign resources.

The deterioration of the exchange position was indicated by the growing delays in the payments for goods to countries which Italy had no clearing agreement with. Even American exporters, who were for some time treated with special consideration owing to the refusal of the United States to participate in sanctions, had to put up with growing delays. The big oil companies, too, had to wait for payment for the oil sold on a strictly cash basis. The Italian Government defaulted on its liabilities to the Soviet for oil deliveries.

It was said, it is true, that the gold reserve of the Bank of Italy was still very large. In fact, some of the credits in London were obtained on the definite assurance that the gold reserve was substantial. There is reason to believe, however, that the gold reserve had reached a point beyond which Signor Mussolini would in no circumstances allow it to decline.

(8) A Second Devaluation?

It is therefore conceivable that rearmament and aggressive foreign policy may to some extent be moderated as a result of the foreign exchange position. Conceivably the initiative taken by Italy in February 1938 for an Anglo-Italian settlement was due as much to the exchange difficulties as to the Central European developments. Possibly the Italian Government may seek to solve this problem by a second devaluation of the lira, an operation which would presumably be referred to as an "adjustment" to the new depreciated level of the French franc. It is also conceivable that Rome will make an attempt to induce the British and French Governments to grant a loan in return for an agreement on the Mediterranean question. It is difficult to imagine, however, that either the British or the French authorities would be willing to become a party to such a bargain. The money paid against that promise would be too much like a Dane-geld, and Kipling was probably right when he wrote:

> **If once you have paid 'em the Dane-geld,**
> **You will never get rid of the Dane.**

The loan would only be used to replenish the raw-material reserve, which would place Italy in a position to return to the old game with increased strength.

There is no doubt that Italy has an excellent record as a debtor. Even during the period of sanctions she met all her banking credits abroad. There is every reason to believe, therefore, that once she has given satisfactory evidence that she is abandoning her aggressive policy, she will have no difficulty in raising credits and loans abroad, even in the absence of active support by any foreign Government. The granting of the credits and loans would, however, have to come as a consequence of a change in her foreign policy and not as part of a political bargain.

However it may be, those who expected that exchange difficulties in Italy would lead to the much-prophesied but never-specified " collapse " will prove to be wrong in the future as they were in the past. Possibly exchange difficulties may lead to a further curtailment of imports for civil requirements, and even to a reduction of imports for armament requirements. Signor Mussolini seems anxious to maintain the gold reserve at its present figure of about £40 million, and in the absence of new credits this can only be done through the elimination of the adverse trade balance. Possibly Italy will take a leaf out of Germany's book and will make more extensive use of the weapon of clearing and compensation agreements in order to secure a larger part of her imports without having to pay cash. It is just conceivable, on the other hand, that in the course of time Italy's foreign policy may show a genuine change for the better, in which case the exchange problem would be solved through loans obtained in this country, France, and possibly the United States.

PART V

WAR FINANCE

CHAPTER XXI

THE SPANISH TRAGEDY

(1) Financial Origins of the Civil War

It is impossible to get away from the fact that most major political troubles, internal or international, have their origins in economic difficulties. It is equally true that most economic difficulties which give rise to political troubles are due to mistaken monetary policy. The origin of the Spanish tragedy provides yet another example of the extent to which mistaken monetary policy can and does ruin a nation and influence the course of world history.

The origins of the Spanish civil war can be found in the monetary policy pursued under the dictatorship of General Primo de Rivera, about eight years before General Franco's insurrection. The chances are that, but for the desire of the Dictator and his Finance Minister, Señor Calvo Sotelo, to maintain the peseta at an unduly high level, Spain to-day would still be a monarchy, and none of the upheavals which began with the collapse of the dictatorship and culminated in the civil war would have occurred.

(2) How Spain lost Her vast War Profits

The Great War left Spain in a highly satisfactory economic and financial position. Neutrality was very profitable to her, and at one time the peseta commanded a substantial premium even in relation to the dollar. Never since the conquistadores opened up the vast resources of the New World for exploitation for the benefit of Spain had such immense wealth been showered upon the country as during 1914–18. Anything Spain produced could be sold to the Allies for fancy prices. The fate of these gains was, however, no better than that of the ill-gotten profits derived from the ruthless exploitation of the South American colonies four hundred years earlier. It led to excessive speculation, and the post-war slump made heavy inroads in the newly acquired wealth. Losses through gambling in German marks on a gigantic scale were even heavier a few years later. Spanish people have always had

an immense admiration for German efficiency and commercial integrity, and they had implicit faith in the eventual restoration of the mark to its old parity even when it was quoted at the rate of millions per peseta. A large part of the war profits of Spain was lost as a result of the financial collapse of the chief victim of the war.

The Bank of Spain, it is true, succeeded in retaining a gold reserve quite out of proportion to the financial and commercial importance of Spain. It was largely the possession of this strong gold reserve in subsequent years that encouraged the Spanish Government to resist the depreciating trend of the peseta. The rise in commodity prices during and after the war was never properly liquidated, so that the peseta became overvalued, to the detriment of export trade. It was allowed to depreciate to some extent, but not to a sufficient extent to restore the equilibrium.

(3) Overvaluation of the Peseta

During the years that followed the mark slump, the internal position, coupled with the reverses in Spanish Morocco, resulted in an adverse trend in pesetas. During 1925–6, however, as a result of the military success in the Morocco campaign and the exceptionally good wine export seasons, the tendency turned in favour of the peseta. This rise became accentuated by heavy speculative operations on the part of Dutch, Swiss and other speculators. By April 1927 the peseta had risen to about 94 per cent of its gold value. At that level it became grossly overvalued compared with its internal purchasing power. During 1928 profit-taking by speculators led to a relapse in pesetas, and political uncertainty resulted in some speculative selling. Señor Calvo Sotelo, influenced by considerations of prestige, decided to intervene to check the depreciation. While in earlier years he had allowed an appreciation to take place in spite of its damaging effects on imports and internal economic conditions, he now set out to prevent a natural adjustment of the exchange to its economic parity. Notwithstanding this official intervention, the peseta had to be allowed to depreciate, apart from temporary recoveries, throughout 1929 and 1930. Even so, the depreciation was not allowed to take its normal course, and for years the peseta was kept at an artificially high level. The Spanish authorities put up a stubborn resistance to an adequate degree of depreciation. To that end they raised credits in London, which were used up in face of the one-sided trend. Further

adverse pressure on the peseta was met by gold exports. Reluctant as the Spanish authorities were to part with gold, they preferred this to allowing the peseta to find its natural level.

(4) Political Effects of Mistaken Monetary Policy

The inevitable result of the prolonged overvaluation of the peseta was economic depression. Although very few people in Spain were in a position to trace the cause of the unsatisfactory situation, most people felt that in some way or other the régime was responsible for it. The result was a growing discontent, leading to the collapse of the dictatorship in 1930. During the following year the Government carried out a *de facto* stabilisation of the peseta with the aid of a credit obtained from the Bank of France, and secured in full by gold. This credit enabled the Republican régime to continue to support the peseta without actual loss of gold. Having inherited a monetary policy of prestige from the preceding régime, the Republican Government had not dared to bring about the downward adjustment of the peseta to an adequate degree. As a result, the Spanish people shared to a large extent the depression prevailing in the Gold Bloc countries. This factor was largely responsible for the disturbed internal political conditions between 1931 and 1936.

It is thus beyond doubt that the misguided monetary policy adopted by Señor Calvo Sotelo was largely responsible both for the difficulties leading to the downfall of the dictatorship and monarchy, and, indirectly, for the difficulties leading to the violent attack on the Republican régime. It is a strange coincidence that, after Señor Calvo Sotelo played such an important part in the financial origins of the Spanish civil war, his assassination in July 1936 should have provided the spark that set Spain aflame.

The civil war was to a large degree the result not only of Spanish monetary policy but also of French monetary policy. Had France devalued the franc in 1935, Spain would have followed her example, and the relief provided by the devaluation of the peseta might have been just sufficient to restore happier conditions in the country. From this point of view, M. Laval's deflationary defence of the franc bears indirectly a large share of the responsibility for the Spanish civil war.

(5) The "Mañana Standard"

The defence of the peseta under the various Republican Governments was all the more difficult since there was a per-

sistent outflow of capital. All the nobility and the wealthy classes played for safety by transferring their money to Paris or London. Such exchange restrictions as existed were not enforced efficiently enough to prevent this outflow, though they were efficient enough to prevent foreign exporters from being paid promptly for their deliveries. Commercial arrears were mounting up, especially in the course of 1935. Towards the end of that year the average length of time British exporters had to wait for payment from Spain was something like ten months. In an article appearing in the January 1936 issue of *The Banker* I described the system prevailing in Spain as " the mañana standard ". The Spanish authorities were too proud to admit the defeat of their efforts to maintain the stability of the peseta, but they were not too proud to keep their commercial creditors waiting. The stability of the peseta was in fact maintained by simply not paying the external commercial liabilities except when exchange was coming in from exports.

Towards the end of 1935 the Spanish Government concluded an agreement with the French Government by which French commercial credits were paid through the sale of gold. British creditors were less fortunate. For many months Whitehall had ignored those who advocated the adoption of exchange clearing as a means of obtaining payment for British exports to Spain. Commercial arrears were allowed to accumulate, and by the time Whitehall had reluctantly decided to adopt clearing at the beginning of 1936, the deadweight debt which constituted the first charge on the resources of the clearing account was much too heavy. In addition, the British negotiators were ill-advised enough to agree that London acceptance credits, which had been granted not to finance British exports to Spain but to finance trade between Spain and foreign countries, should be included among the arrears that constituted the first charge on the proceeds of the clearing. It was argued that the London banks could not very well be left out. As a matter of fact, having received the doubtful assurance that they would be repaid through the working of the clearing or, failing that, through direct transfers by the Bank of Spain, the London banks and acceptance houses proceed to grant Spain new credits in addition to those existing already, before the latter were repaid. They were warned that they should not rely upon these new credits being repaid out of the clearing, but owing to the dearth of acceptance business they were unable to resist the temptation. Thus it was that when in the summer of 1936 the civil war broke out, the amount of

outstanding banking credits in Spain was exceptionally large. The clearing was not in operation for long enough to secure the repayment of more than a small part of the commercial and banking arrears.

(6) Influence of French Monetary Policy

Throughout the period between the establishment of the Republic and the outbreak of the civil war, unfavourable economic conditions stimulated extremist movements to no slight degree. It provided excellent opportunities for Communist and Anarchist agitators, especially in the industrial and mining districts. The result was that even after the advent of the Government of the Popular Front in 1936, Communist and Anarchist elements caused the Government immense difficulty, by their unruly behaviour. There was utter lack of discipline, even among the supporters of the Government, and the excesses which the authorities were unable to prevent provided an excuse for General Franco's rising.

Even so, the revolt might never have materialised but for the support received from Italy from the very outset. The Italian intrigues were largely the result of the Socialist victory in France, which gave rise to fears in Rome that a Spanish-French alliance would turn the Mediterranean balance of power strongly against Italy. Had the French election in 1936 not brought in a Socialist Government, it is possible that the Italian support of General Franco's movement would have been less open and on a much smaller scale. And since the Socialist victory in France was the direct consequence of M. Laval's deflationary policy, that ill-advised policy was responsible also in this sense for the unfortunate developments in Spain.

CHAPTER XXII

SPANISH WAR FINANCE

(1) Moratorium

The financial conditions inherited by the Spanish Popular Front Government from its predecessor were anything but enviable. Efforts to straighten things out, especially as far as external liabilities were concerned, were frustrated by the outbreak of the civil war, barely six months after the advent of the new Government. From that time onward, financial considerations faded into insignificance compared with the necessity of defending the republic against the insurgents and their Italian and German allies. As a result of General Franco's insurrection, Spain was divided into what were to all intents and purposes two separate countries, whose financial conditions developed independently of each other.

The immediate effect of the outbreak of the civil war was the suspension of all external payments, financial or commercial. Even the execution of foreign exchange contracts with Spanish banks was stopped by the moratorium declared by the Madrid Government. This created considerable inconvenience to foreign exchange markets all over the world, since in the absence of deliveries of pesetas by the Spanish banks, the banks abroad were in turn unable to execute their foreign exchange commitments. It was months before it became possible to liquidate these commitments. By the end of 1936, however, the execution of most foreign exchange contracts, entered into before the civil war, had been completed.

(2) Payment of External Credits

The problem of other financial liabilities and of commercial liabilities was much more difficult to solve. The Anglo-Spanish exchange clearing was suspended and the amount of about £1½ million accumulated on account of the Spanish clearing in London was blocked by the British authorities pending the general disentanglement. Considerable amounts of Spanish credits were outstanding in London, due for repayment during the early part of 1937. The attitude of the Spanish Govern-

ment towards the payment of these credits was therefore a matter of importance to the London banks. The bills issued under credits renewed before the exchange clearing agreement became operative received the endorsement of the Government Exchange Office and the Bank of Spain. The Spanish authorities made a praiseworthy effort to meet these bills on maturity. They transferred a first instalment of a quarter of a million pounds to the London account of the Bank of Spain with Martins Bank for the purpose of meeting the first batch of bills falling due. When the bills were presented, however, the London office of the Bank of Spain refused payment on the ground that Martins Bank had blocked its balance available for the purpose of paying the bills. Martins Bank took this step on instructions received from the Burgos branch of the Bank of Spain, which claimed that, since the gold out of which the payment was to be made was the property of the shareholders of the Bank of Spain, its disposal by the Government was illegal. On the opposite side it was argued, however, that the bills constituted a liability of the Bank of Spain and were therefore a first charge on its assets, and that in any case the Republican Government, recognised by the British Government as the only legal authority in Spain, was entitled to commandeer the resources of the Bank of Spain in accordance with its own laws. It was also pointed out that the argument that the gold reserve of a Central Bank constitutes the private property of its shareholders is entirely untenable. Nevertheless, Martins Bank decided to be on the safe side and refused to part with the amount, pending legal action or the termination of the civil war.

After a few weeks of hesitation, the Republican Government provided fresh funds to meet all the bills drawn upon pre-clearing credits. This gesture was all the more appreciated since it was in sharp contrast with the attitude of the insurgent Government in the matter of Spanish external liabilities. Those bills, after all, represented the liability of the whole of Spain and not only of Government-controlled territory, and default on them was damaging to the reputation of Spain as a whole. The fact that while the insurgent Government did its utmost to stop the payment of those liabilities, the Republican Government went out of its way to meet them, was compared in the Press to the attitude of the two women who demanded Solomon's judgment in their dispute over the child. Evidently the Republican Government had the honour of Spain more at heart than the insurgent Government, which appeared to

have come under the influence of Germany in the matter of commercial morality.

The banks were less fortunate about the credits they granted after the conclusion of the clearing agreement. They had, however, largely themselves to blame for having entered into these credits against the emphatic warnings of the Treasury. What is more unfortunate is that a large amount of commercial arrears which were to be paid off through the working of the clearing agreement have remained unpaid. Only a small part of those liabilities is covered by the sterling balances which have been accumulated by the Anglo-Spanish Clearing Office, and there is no hope of a settlement until long after the civil war has ended, when the restoration of normal conditions makes it possible to resume the working of the clearing agreement.

(3) Bank of Spain's Gold

It is safe to assume that payments were made out of the gold reserve of the Bank of Spain. No definite information was available about the fate of that gold reserve. From time to time it was suggested that it had been transferred to Paris, London or even Moscow. Mysterious individuals are said to have offered gold which nobody in the market was prepared to touch. At the beginning of 1937 the Republican Government issued an emphatic denial of these stories, and stated that the gold reserve was still intact. It was impossible to ascertain the truth, which was probably somewhere between the two versions. The Republican Government must have spent at least a large part of its gold stock on arms purchased abroad. Admittedly, it can be taken for granted that Russia was prepared to deliver war material even without any cash payment, and the same was probably true of France to some extent. On the other hand, purchases made elsewhere had to be paid for in cash, and so had the fabulous freights which had to be paid to neutral ship-owners who were prepared to run the risk of keeping up services to Government-controlled Spanish ports. It is even said that some of the war material purchased by the Government came from Germany, which country delivered war material to General Franco for love or for iron ore, and to the Government for the much-coveted gold.

(4) The War Material Racket

Much of the Spanish gold must have disappeared at the hands of dishonest intermediaries in the armament traffic that

developed between Government-controlled Spain and other countries. In their keenness to secure quick delivery of the badly needed war material, Government agents abroad were often grossly careless in the choice of the people with whom they transacted business. This was all the more damaging since prepayment in gold was the generally adopted rule in the armament trade with Spain. By the time the Government had learnt its lesson, it must have lost considerable amounts of gold, and shady merchants, agents and ship-owners must have made small fortunes at its expense. Greeks were particularly prominent in this kind of transaction. One instance is especially worth quoting as a proof that fact is sometimes stranger than fiction. A Greek merchant sold to the agent of the Spanish Government a consignment of arms, against prepayment. Although the arms themselves could not be insured, he insured at Lloyds both the ship and the cargo that was to cover the arms. He then got in touch with the agents of the insurgent Government, and notified them of the time when the ship was due in Spanish waters, on the understanding that General Franco's navy would capture it and he would receive compensation for the ship and cargo. This scheme was carried out, and a few hours after the pre-arranged capture of the ship it was duly scuttled in accordance with the best Greek traditions. As a result, the merchant received payment (1) from the Republican Government, (2) from General Franco, (3) from Lloyds—and in any case the arms had never been put on board ship.

Innumerable similar stories were in circulation. If even 10 per cent of them were true, the loss of gold through fraud and double-dealing must have been considerable.

(5) Lack of Industrial Discipline

The adverse trade balance of Government-controlled Spain must also have made heavy inroads in the gold reserve. Export trade was strongly affected by the disorganisation of production, especially during the early period of the civil war. This was partly the inevitable consequence of the mobilisation of the working classes, and of the difficult transport conditions. To a large extent, however, it was due to the same lack of discipline which to a less degree characterised the first period of the French Front Populaire régime. In Spain, industrial discipline ceased to exist. Employers, managers and foremen were executed or imprisoned, and this alone was sufficient to paralyse production for a long time. Skilled

miners and factory hands were required for military service, since they were the most dependable elements. The less responsible elements among manual labourers formed bands, preferring looting to working. It was a long time before the Government succeeded in enforcing some sort of discipline, and even at the time of writing conditions of production and export in Government-controlled Spain leave much to be desired. Since it was necessary to continue to import indispensable food, raw materials and manufactures, apart from war materials proper, it is safe to take it for granted, even in the absence of dependable figures, that the trade balance in Government-controlled Spain was strongly adverse from the very outset.

Given the lack of organisation and discipline, it is remarkable that the Republican Government was able to finance the prolonged warfare without any evidence of that advanced stage of crude inflation which characterised all the revolutionary movements in Central and South-Eastern Europe at the end of the last war. Admittedly, the resources of the wealthy classes were drawn upon ruthlessly. There was also an increase of the note issue, but not to a sufficient extent to bring about a complete depreciation of the notes, as in Soviet Russia, Hungary, Austria, Germany and Poland during the first few post-war years. Even eighteen months after the beginning of the civil war the exchange rate of Government-controlled Spain was quoted at 70 to 100 to the pound. The quotation was largely nominal, but nevertheless it indicated that inflation in Government-controlled Spain had not yet got out of control.

(6) How Franco Pesetas were Supported

At an early stage of the civil war a disparity developed between the Franco peseta and the Government peseta. The Bank of Spain's notes in circulation in insurgent-controlled territory were stamped, and unstamped notes were declared invalid. The Franco Government issued peseta notes printed in Germany. The exchange rate of the Franco peseta had all along been much more favourable than the rate of Government pesetas, in spite of the fact that while the Government had obtained possession of the full gold reserve of the Bank of Spain the notes stamped by General Franco had virtually no metallic cover. The more favourable rate quoted for Franco pesetas—the official rate was 42 to the pound—was due to better economic organisation and industrial discipline, together with the command of the sea, which enabled insurgent-

controlled Spain to export freely. It is true that part of her exports of copper and iron ore had to be diverted to Germany and Italy, and that payment for these deliveries was made in kind. The reason why Germany and Italy were not given the full possession of the mineral resources of insurgent-controlled Spain was that General Franco's Government needed foreign exchange and could only obtain it through exporting some of these minerals to Great Britain and elsewhere. Some exchange was obtained also from the "tourist traffic" represented by the spendings of the German and Italian expeditionary forces.

What was much more important, a large number of wealthy people were able to rescue a large part of their wealth from Government-controlled territory and remove it to insurgent-controlled territory. The insurgent Government accumulated substantial amounts through the surrender, voluntary or compulsory, of foreign assets and gold held by residents in the territory which it controlled. These assets must have been substantial. After all, the wealthy classes had ample warning that trouble was brewing, and it was a matter of elementary wisdom for them to transfer at least part of their resources abroad. Many of the wealthy people voluntarily surrendered part of their assets in order to assist General Franco against the much-hated Republican régime. The Spanish royal family itself is known to have contributed quite a substantial amount to General Franco's war chest. It has also been suggested that the Church of Rome gave him by no means inconsiderable financial assistance.

(7) Effect of Discipline

All this was, however, not sufficient to cover the growing requirements of the prolonged warfare. The Burgos Government therefore decreed that Spaniards in insurgent-controlled territory, and also Spaniards living abroad but owing allegiance to General Franco, must surrender all their foreign assets. Substantial amounts are understood to have been collected as a result of this decree. In London alone the funds accumulated from this source by General Franco's agent were very considerable, and at one time the sterling balance on his account with a leading merchant banking firm is said to have run into seven figures.

By far the most important factor in keeping up the value of the Franco peseta was the iron discipline restored in production as soon as the resistance of Republicans had been

broken. Thanks to this, supplies of goods in insurgent-controlled territory remained plentiful, and prices did not rise to anything like the extent to which they rose in Government-controlled Spain. Needless to say, the exchange rate of Franco pesetas is as nominal as that of Government pesetas. The whole foreign trade of both parts of Spain is done on a cash basis and on a foreign currency basis. Market transactions in both types of pesetas are very few and far between, and it would be impossible to find buyers for large amounts of either of them. The significance of the artificial rate quoted for Franco pesetas lay in the fact that British and other foreign mining companies and other firms operating in insurgent-controlled territory were compelled to surrender the proceeds of their exports on the basis of that rate. Since the internal depreciation of the peseta was by no means negligible even in insurgent-controlled Spain, the increase in the cost of production made it difficult for foreign firms to work without incurring a loss. They were nevertheless compelled to keep up their production, a fact which is worth bearing in mind in face of the frequent allegations that the Republican Government has expropriated foreign owners of enterprise in territory under its control.

(8) Lesson of Spanish Experience

The lesson taught by the experience of Spanish war finance is that it is possible to conduct modern warfare on a large scale even in the absence of adequate financial resources in the form of accumulated capital or taxable current incomes. It is true that Government-controlled Spain started with a substantial initial advantage in the form of the gold reserve of the Bank of Spain, but since that gold was not issued in internal circulation, it only assisted the Government in its external transactions. Internally both General Franco and the legitimate Government started their campaign by simply compelling the population under their control to accept inconvertible notes in payment for deliveries. The confiscation of privately-owned assets helped the Government at the initial stages, but these assets could only be confiscated once, and in seizing them the Government effectively killed the goose that laid the golden eggs. Subsequently the restoration of discipline in the economic and financial management of the country made up for the lack of additional rich people to be soaked.

The lesson taught by the Spanish experience is worth

remembering, if only in order to avoid a repetition of the mistake made by so many economists and statesmen in 1914, when it was a widespread belief that owing to the high cost of modern warfare the war would have to end in a few months. The mistake was made a quarter of a century ago, and human memory is short. The Spanish experience provides a reminder that financial limitations to modern warfare are virtually non-existent.

CHAPTER XXIII

THE MONETARY FACTOR IN JAPAN'S FOREIGN POLICY

(1) Overvaluation of the Yen

It is not sheer coincidence that the three countries which have adopted a foreign policy aiming at expansion are densely populated and have inadequate raw material reserves of their own. Their populations are increasing rapidly, and as a result they tend to become increasingly dependent on foreign raw-material resources. Nor is it mere coincidence that considerations of monetary policy have played an important part in accentuating the expansionary trend of their foreign policies during recent years. Mussolini's Abyssinian adventure was largely the outcome of his stubborn defence of the lira. Germany's difficulties in finding adequate markets for exports were largely the result of the overvaluation of the reichsmark. Our present task is to examine how far monetary considerations were responsible for the accentuation of the Japanese expansionary policy in relation to China during 1937.

As is well known, the economic and financial position of Japan suffered heavily as a result of the earthquake of 1923. The result was a heavy depreciation of the yen, an increase of public and private indebtedness and a rise in the price level. Notwithstanding this, the Japanese Government, inspired by a policy of prestige, restored the yen to its pre-war parity in 1930. The result was that Japanese trade was handicapped by the overvaluation of the yen, and the lack of raw-material resources began to present an increasingly acute problem. Between 1929 and 1931 Japan's foreign trade contracted by more than 40 per cent.

(2) Invergordon and Manchukuo

Although it would be idle to attribute the Japanese decision to annex Manchukuo entirely to economic and financial considerations, the export difficulties due in part to the overvaluation of the yen must have contributed towards the decision to no slight degree. Financial considerations also

played an important part in the choice of the moment for action. During the summer of 1931 Great Britain was in the throes of an acute financial crisis and was obviously not in a mood to fight unless her vital interests were involved. The attempt to save the pound through rigid economies resulted in the Invergordon naval mutiny in September 1931, and a few days later Japan landed an army in Manchukuo. It was reasonably safe to assume that in the absence of active British support the United States would not intervene. This assumption proved correct, and the ineffectual protest from Geneva did not prevent the complete conquest of Manchukuo and the establishment of an autonomous state under Japanese control.

For more than two months after the suspension of the gold standard in Great Britain the yen was maintained at its old parity. Its maintenance involved, however, very heavy sacrifices in the form of loss of gold, not only because of the effect of the depreciation of sterling on Japanese trade but also through the flight of Japanese capital, mostly to the United States. Moreover, the cost of the Manchukuo campaign increased both trade and budgetary deficits. Eventually the suspension of the gold standard was decided upon in December, 1931.

(3) Undervaluation of the Yen

Once having abandoned the futile attempt to maintain the yen at its old parity, the Japanese Government for a long time refrained from interfering with its sharp depreciation. As a result, the yen depreciated to a much larger degree than either sterling or the dollar, and was considerably undervalued for a time. Consequently, Japanese exporters found it easy to compete with their foreign rivals in every market which was not closed to them by quotas or import restrictions. Thanks to the low cost of production, coupled with a highly favourable exchange rate, exporters were able to get over even the highest customs barriers. Japanese competition became a formidable factor to Lancashire even in the British Dominions and Crown Colonies, and to a much larger extent in countries such as the Latin-American states, which had no specific reason to discriminate between British and Japanese trade. The prolonged depreciation also assisted Japanese export trade to a considerable degree. It was the period of "the survival of the cheapest". Owing to the high standard of living in Great Britain and other Western European countries and in the United States, it was impossible for those countries to compete

with the prices quoted by Japanese exporters. In many instances the latter quoted prices 50 per cent below the next lowest offer. Even if the difference was due in many instances to inferior quality in the material or inferior workmanship, due to lack of experience, the buyers were unable to resist the temptation to accept the lowest offer.

By October 1934 the depreciation of the yen had reached about 66 per cent of the old gold parity. Since November 1932 it had been connected to some extent with sterling at the average rate of 1*s.* 2*d* per yen, which is about 40 per cent below the old sterling–yen parity. From 1934 onward the yen became rigidly linked to sterling, and when the latter became relatively stable in relation to gold and the dollar the yen also returned to a régime of comparative stability.

(4) Rise in Japanese Price Level

Until about 1936 the yen continued to be undervalued and Japanese export trade continued to be at an advantage. The stimulus to exports of the low yen rate was, however, wearing away rapidly. Internal prices and costs were rising fast, partly as a result of continued heavy expenditure on rearmament and partly as a result of the strengthening of the labour movement. Wages, which until a few years earlier had been incredibly low, had to be raised under Socialist pressure. This, together with a series of budgetary deficits, resulted in a growth of the consumers' purchasing power, and this in turn contributed to the rise in its price level and the increase of the adverse trade balance. The need for raw material and food imports was increasing rapidly. On the other hand, Japanese exporting capacity was affected by the higher cost of production and also by the world-wide recovery through which many markets could afford to revert to the purchase of the more expensive manufactures of the Western countries.

The social progress in Japan between 1931 and 1936 bore much similarity to that which took place in France following the Popular Front victory in 1936. The strengthening of the Labour movement necessitated the granting of higher wages and better working conditions. Such a development is bound to affect the exchange position unfavourably, and unless a country is able and willing to lose gold on a large scale it has to submit to a depreciation of the exchange. This fact was not adequately realised in either France or Japan. In both countries the official policy aimed at maintaining the exchange in face of social developments making for depreciation.

(5) Exchange Difficulties and Expansionary Foreign Policy

By the end of 1936 the Japanese exchange position was beginning to give rise to grave concern. The Japanese authorities might have been able to solve the problem by cutting down rearmament expenditure and rearmament imports. The other possible solution was to allow the yen to depreciate once more, thereby providing at least temporary relief. The Government was not prepared to resort to either of these solutions. After several years of comparative stability it was once more considered a matter of prestige to keep the yen at 1*s.* 2*d.* even at the cost of sacrifice. The reduction of rearmament expenditure and of raw-material imports for rearmament purposes was politically impossible, owing to the influence of the army. The Government followed Signor Mussolini's example of two years earlier by adopting exchange restrictions at the beginning of 1937 and by embarking upon the Chinese campaign during the second half of that year. The exchange restrictions failed to check the adverse trend in trade, and by the middle of 1937 Japanese foreign trade was faced with the same difficulties as it had been six years earlier. The position was worse, since a large part of the substantial gold reserve which Japan had possessed in 1931 had been used up in the meantime. Just as in 1931 the Government sought to solve the problem by the conquest of Manchukuo, so in 1937 it decided to secure markets in China, if necessary by armed intervention.

It is not mere coincidence that during the years 1932 to 1936 while the yen was undervalued the expansionary policy of the military party in Japan was kept in check. It was only in 1931 and 1937, when the yen had been overvalued for some time, with adverse consequences to Japanese export trade, that the expansionists gained the upper hand in the control of Japanese foreign policy.

(6) "Temporary" Advantages of Currency Depreciation

The example of Japan is often quoted in orthodox quarters to prove that such advantages as may be gained from the depreciation of a currency are of a purely temporary nature. Even if this is so, a period of five years of comparative prosperity is something not to be despised. In any case, Japan was no worse off after her period of prosperity than at the beginning, and "it is better to have loved and lost than never

to have loved at all." In the case of Japan, the internal advantages of a depreciation of the currency were tempered by the fact that the extent of the internal, compared with the external, indebtedness was small. Countries whose indebtedness consists mainly of internal debts stand to benefit to a much larger degree by the depreciation of their currency. It is conceivable that, had Japan allowed the yen to depreciate further in 1936 or 1937, the uneasy equilibrium established among the Western currencies might not have been able to withstand the new pressure, and there might have been another all-round depreciation. In that case, the depreciation of the yen would have resulted indirectly in a reduction of Japan's external indebtedness.

From a purely economic and financial point of view, it is doubtful whether the results of the Chinese campaign will provide a solution comparable to that of the depreciation of the yen. The experience of Manchukuo has proved that, to begin with, at any rate, new territory is a liability rather than an asset. The amount of new capital absorbed by Manchukuo was far in excess of the exports absorbed by the newly opened market. It stands to reason that the same would be true concerning China, but to a much larger degree.

Thus from the point of view of both Japan and the world as a whole, it would have been better if the yen had been allowed to find a lower level, as a natural consequence of the increase of wages and prices during 1935 and 1936. The Japanese experience shows that once a rate, however fortuitous, happens to have been maintained for some years, its defence comes to be regarded as a matter of national prestige.

CHAPTER XXIV

FINANCIAL DIPLOMACY IN CHINA

(1) Financial Assistance without Co-operation

China constituted the obvious sphere for Japanese expansion. It had been evident for a long time that sooner or later Japan would penetrate into China: the question was only whether it would be a peaceful penetration or armed conquest. Time after time Japan made it plain to the Western powers that she considered China her preserve. It would be idle to speculate whether Japan would have been satisfied with an adequate degree of economic penetration, or whether the expansion of her trade with China would in any case have been followed by an attempt to secure political control.

It was for the Western powers to decide whether to give China their full financial, political and, if necessary, military support against Japanese penetration, or whether to recognise the inevitability of Japanese expansion and act accordingly.

The Western powers, however, chose the worst of both worlds. The experience of Abyssinia was repeated on a gigantic scale. China received a certain amount of encouragement from Great Britain, the United States and Russia—sufficient to give rise to hopes which stiffened her resistance to Japanese penetration. When it came to the point, however, the Western powers and the United States were not prepared to fulfil the hopes they had raised.

While from the Russian side the encouragement given to China consisted mainly of the strengthening of her forces in Eastern Siberia, from the British and American side encouragement came in the financial sphere. It consisted mainly of advice and assistance in the execution of monetary reform, without the co-operation of Japan. The wise course would have been to call together a conference of the Powers concerned with the fate of China, and work out jointly a monetary reform scheme, which the country badly needed. It was to the interest of Japan to at least the same extent as of Great Britain and the United States that the chaotic monetary conditions in China should be brought to an end.

Whether Japan would actually have co-operated to that end with the other Powers, or whether she would have adopted a truculent attitude on the ground that Chinese monetary reform was Japan's private affair, it is impossible to say. An attempt ought to have been made to ascertain if Japan were willing to undertake constructive co-operation. The only step taken in that direction was the Tokyo visit of Sir Frederick Leith-Ross on the occasion of his visit to China in 1935, in connection with his Nanking mission. Since, however, Japan suspected that the Chinese currency reform was being elaborated under the auspices of Great Britain, she was not prepared to endorse the scheme. Apart from this inadequate attempt, both Great Britain and the United States played a lone hand in China. To a very large extent they worked against each other at a time when co-operation was essential.

(2) Disastrous American Silver Policy

American intervention in the monetary affairs of China might be described as a farce, if it had not produced such disastrous results. As is well known, one of the declared objects of the ill-advised silver-buying policy was to assist China and to increase the purchasing power of the Chinese people, thereby to contribute to the recovery of world trade. If in order to attain that end the United States authorities had merely secured the stability of silver at a reasonable price, the policy would have provided a most valuable contribution to the improvement of conditions in China and in world trade in general. Under the influence of Senator Pittman's silver group, however, the Washington Administration decided to embark upon a fantastic policy of raising the price of silver to a highly artificial level. To suggest that this was to the interest of the Chinese people was the height of absurdity. As is well known, at that time China was on the silver standard, and consequently a rise in the world price of silver meant the appreciation of the Chinese currency. It is true that as a result of that appreciation it was cheaper for China to buy goods abroad, and from this point of view the American silver-raising policy appeared to lead to an increased Chinese demand for foreign goods. What President Roosevelt's advisers overlooked was that an appreciation of the Chinese currency through a rise in the world price of silver meant wholesale deflation in China, with all its adverse effects on Chinese production, trade and purchasing power.

(3) Financial Crisis in China

Until 1934 China had succeeded to a remarkable degree in keeping aloof from the world depression. In the course of the early years of the depression, the price of silver continued to fall in terms of gold currencies. As a result, silver remained comparatively stable in terms of commodities. Thanks to this, the silver-using countries escaped the worst of the depression caused by the fall in commodity prices in terms of gold. Even though the fall in the price of silver discouraged imports, from the point of view of the Chinese people this was no great disadvantage—in fact, it encouraged the development of national production. In the circumstances there was no justification whatsoever for suggesting that a rise in the price of silver would be to the interests of the Chinese people. Whatever other arguments there may have been in favour of President Roosevelt's silver policy, the argument that the price of silver was to be raised in order to assist the poor destitute Chinese people was utterly false.

With the rise in the price of silver in 1934 and 1935, a financial and economic crisis broke loose in China with elemental force. Commodity prices fell, and Chinese producers and merchants suffered heavy losses. China began to enjoy the blessings of deflation, which she had been spared, thanks to the fall in silver, until 1934. At the same time the high price of silver induced many Chinese holders to sell their holdings abroad. There was a heavy outflow of silver from China, depleting to a large degree the supply of currency and accentuating the deflationary effect of the rise in silver. As a result of the shortage of currency, a number of Chinese banks suspended payment early in 1935. Conditions assumed a panic-like character.

(4) Demonetisation of Silver

In order to defend herself against the deflationary effect of the rise in the price of silver, the Chinese Government decided towards the end of 1934 to dissociate the Chinese currency from the metal. The first step to that end was the imposition of an export duty on silver and the adoption of an equalisation charge payable by exporters, which should be equal to the difference between the official Chinese price of silver and the London market price. In theory this measure was calculated to check the outflow of silver, since the payment of this equalisation charge made the shipment of silver unprofitable. In

practice, however, owing to the inefficiency of Chinese administration, silver was smuggled out of the country in huge quantities. Moreover, fears of an aggravation of the crisis led to the export of capital even though the shipment of silver yielded no profit.

By the end of 1935 it had become evident that the policy aiming at raising the price of silver had been a ghastly mistake. The United States authorities were no longer prepared to pay the higher price to which the speculative anticipation of a further rise in the official American price had brought the metal during the spring of that year. During the autumn there were heavy liquidations. It was only with reluctance that the United States authorities, in order to avoid complete disaster, took up the amounts thrown on the market. The price of silver was allowed to fall sharply. In theory this fall should have provided relief to China to the same extent to which the rise in the price of silver had caused inconvenience. In practice, however, the shock was too violent to produce anything but bad results. There was another crisis with bank suspensions, and the atmosphere once more became thoroughly panicky.

(5) The Leith-Ross Mission

It was in this atmosphere that the financial mission headed by Sir Frederick Leith-Ross, and including Mr. Edmund Hall-Patch (former Financial Adviser to the Siamese Government), and a member of the staff of the Bank of England, arrived at Nanking. The mission established contact with the Japanese Government, but judging from the subsequent attitude of the latter towards the Chinese monetary reform, it is evident that no understanding was reached. Soon after the arrival of the mission, the terms of the Chinese currency reform were announced. Although it was emphasised that the reform had been elaborated by the Chinese Government alone, it is not altogether surprising that the presence of the British financial mission at the very moment when the reform was being elaborated was generally regarded as being something more than coincidence. Tokyo strongly resented what it regarded as a British attempt to secure influence in Nanking.

There was no reason why the Japanese Government should in any way resent the terms of the monetary reform in itself. It consisted of the demonetisation of silver, which may have been a blow to the United States from the point of view of the success of her silver policy, but which certainly suited the

interests of Japan. Since the Chinese currency became more or less pegged in relation to sterling, China joined the Sterling Bloc, and since Japan also maintained a fixed ratio between the yen and sterling, the result of the reform was that the exchange rate between China and Japan became virtually stable. Japan could not possibly have desired anything better from the point of view of trade. After all, the increase of trade between the countries of the Sterling Bloc amply proved that the stability of exchange between countries encourages trade between them. If only Japan had been given the moral satisfaction that this monetary reform was carried out under her auspices instead of those of Great Britain, it might have gone a long way towards establishing a better atmosphere in the Far East.

(6) A Political Blunder

Considerations of prestige carry much more weight in the Far East than in Europe, and some face-saving arrangement by which Japan could have been enabled to claim credit for the Chinese monetary reform might have done much towards the maintenance of peace or, at any rate, the postponement of Japanese aggression if it was inevitable. Bearing this in mind, one is bound to realise that the excursion of Sir Frederick Leith-Ross and the Treasury into the sphere of foreign policy was not exactly fortunate. The basic fact of the situation was that Japan had a strong army and navy on the spot and was quite prepared to use them, while Great Britain had no intention whatsoever of becoming embroiled in a war with Japan over China. This being so, it was useless to be clever in the sphere of financial diplomacy, since the guns were bound to have the last word.

It is impossible to get away from the fact that the dispatch of a British financial mission to China was a first-class political blunder. The original intention was to appoint an international commission, which would have included as the French member M. Le Norcy, assistant Financial Counsellor at the French Embassy in London, and members of other nationalities. For some unknown reason this plan was dropped, and a strong all-British delegation was sent out. The fact that in addition to such a prominent personality as the chief Economic Adviser to the British Government, the former Economic Adviser to the Government of Siam was included in the mission, made it inevitable that it should attract much publicity. The Government ought to have known how sensi-

tive Japan was towards what had always been regarded in Tokyo as trespassing on her preserves. The reform scheme might have been elaborated in London and communicated to Tokyo as a tentative suggestion through the usual diplomatic channels without any publicity. It might then have been presented as coming from Japan, and British diplomacy in Nanking should have used its influence to induce the Chinese to accept it as such. Had this been done, history might have taken a different course.

(7) Effects of Monetary Reform

Japan's disapproval of the Chinese monetary reform manifested itself immediately by the refusal of the Japanese banks operating in China to comply with the law compelling all banks to surrender their stocks of silver. This refusal was meant merely as a gesture to indicate the Japanese protest, and subsequently the Japanese banks agreed to comply with the request and fall in line with other foreign banks. The Japanese resentment over the monetary reform grew, however, as and when it became evident that the Japanese anticipation of the failure of the reform was unfounded. In fact, the reform was successful beyond all expectation. Ever since November 1935, when it was carried out, the exchange rate of the Chinese dollar has been kept remarkably stable in terms of sterling and dollars. Admittedly, this was due to a large degree to American assistance given to the Nanking Government. Although the monetary reform carried out without the co-operation of the United States was at first resented in Washington, President Roosevelt proved to be a good loser, and in 1936 an agreement was reached whereby part of the Chinese silver stock was to be exchanged for American gold. It is true that in the absence of such an agreement the United States authorities would have had to buy up the Chinese silver as it was realised in the London market, in order to avoid a slump. From a technical point of view the direct purchase of the metal was a better solution, as it avoided a persistent selling pressure in the London market, evidence of which might have induced other holders of silver to liquidate in haste. It was largely thanks to this transaction that stability in the silver market was maintained from the end of 1935 until the end of 1937. From a political point of view, however, it was a blunder to antagonise Japan by the publicity given to the purchase of the silver. As in the case of the Chinese monetary reform, it would have been

more diplomatic to arrange the transaction as a matter of routine.

(8) Chinese Resistance Encouraged

It is by no means certain that if the Chinese monetary reform and the subsequent silver transaction had been handled more tactfully the Japanese military party would not still have forced the Government to pursue an expansionary policy. The experiment of allowing Japan to increase her economic and financial influence over China would, however, have been well worth making. It is true that the amount of British and American commercial and financial interests involved is very large. But the cost of a war with Japan would wipe out in twenty-four hours at least twelve months' profit on Chinese trade or twelve months' interest on Chinese investments. Given the fact that neither London nor Washington was prepared to go to war with Japan for the sake of defending commercial and financial interests in China, the right course would have been to prevail upon the Nanking Government to allow a certain degree of economic and financial penetration by Japan. Instead, the show of financial assistance, together with vague promises of loans, made to Mr. Kung on the occasion of his visit to Europe, encouraged the Nanking Government to resist Japanese economic penetration and thereby to increase the likelihood of Japanese armed intervention.

(9) German and Italian Duplicity

British and American diplomacy was by no means alone to blame for the mismanagement of the Far Eastern situation. German and Italian intrigues also played a very large part. Germany concluded important barter agreements with China, whereby she supplied arms in return for raw materials. She also supplied the Chinese Government with military advisers and instructors. At the same time, the Italian Government sent out Signor de Stefani, a former Minister of Finance, to advise the Nanking Government on financial matters. He succeeded in conveying the impression to Nanking that the Italian Government was still as pro-Chinese as it had been some years before, when Signor Mussolini was as free with anti-Japanese statements as he is now in showering abuse on the democratic countries. Apparently he conveyed the impression that Count Ciano, Signor Mussolini's son-in-law and Italian Foreign Minister, who had become strongly pro-

Chinese and anti-Japanese while he was Consul-General in Shanghai, still maintained the same attitude. It is no wonder that the Nanking Government, in shaping its policy towards Japan, was under the false impression that it could rely upon the active support of all the leading European powers, and of the United States. Possibly this was exactly the object of the German and Italian intrigues. It suited the book of Berlin and Rome that trouble should arise in the Far East. What is deplorable is that Great Britain and the United States, instead of seeking to counteract the activities of German and Italian diplomacy, played into the hands of their opponents.

CHAPTER XXV

HOW THE SINO-JAPANESE WAR WAS FINANCED

(1) No Currency Depreciation

Little more than a year after the beginning of the Spanish civil war, China too became the scene of active warfare. At first it appeared as though the conflict, like the previous armed conflicts between China and Japan in recent years, would be short-lived. On previous occasions the Chinese Government, after having put up a show of resistance, yielded to superior force, and the hostilities soon came to an end. This time, however, Chinese resistance was much more stubborn and desperate than on any previous occasion. Month after month the war continued, and at the time of writing there seems to be no sign of its early termination.

Considering that both China and Japan have large and expensive armies in the field, the war must be very costly indeed to both sides. Those experts who prophesied that it could not last more than a few months, either because it would lead to the complete disintegration of the Chinese administration for lack of financial resources, or because it would ruin Japan financially, are baffled by the fact that the Governments of both countries appear to be able to finance the warfare. What is even more unexpected is that both China and Japan have succeeded in maintaining their exchanges at par up to the time of writing. Speculators who sold yen or Chinese dollars last summer are beginning to realise that, even if by carrying their bear positions long enough they may still make a profit, the money will not have been easily earned.

(2) Deflation in China through Moratorium

The maintenance of the Chinese currency at par was the result of a successful move on the part of the Chinese authorities, by which they followed the German example of 1931. They declared a prolonged Bank Holiday, thereby blocking all the deposits of Chinese currency. Only small amounts necessary for current requirements were released. As a result

of this move, the flight of capital was made much more difficult. It was necessary to resort to such drastic measures, for, in contrast to the patriotic attitude of the lower and middle classes, the Chinese wealthy classes were only concerned with transferring their capital to safety. As a result of the blocking of the Chinese currency deposits, an acute scarcity of currency was created. To overcome this, industrial and commercial concerns and even private individuals were compelled to sell some of their foreign exchange holdings, so that by the end of September the Chinese authorities had actually added to their foreign exchange reserves. Subsequently the blocked deposits were allowed to be used for certain operations, but owing to the limitation of the uses to which they might be put, their owners were prepared to sell them at a small discount.

Needless to say, these Draconian measures inflicted much hardship upon Chinese trade, and many otherwise solvent merchants were unable to meet their liabilities. Foreign firms were also heavily affected by the measures, since non-payment on the part of their Chinese business connections meant that it was difficult, if not impossible, for them to execute foreign exchange contracts and other commitments. Notwithstanding the grave situation thus caused, the measures were justified from the point of view of the efficiency of the defence of China, not only on the ground that they checked the flight of capital but also because of their deflationary, or rather, anti-inflationary, effect. Although the Government succeeded in raising some funds through borrowing, it was inevitable that it should depend largely upon the printing press for financing the war. But for the blocking of the deposits, military expenditure would immediately have created an inflationary effect.

(3) No Inflation

As it was, the amounts spent merely took the place of the blocked deposits. Owing to the monetary stringency caused by the blocking of deposits, the new notes were eagerly welcomed wherever they were used in payment. But for the blocking arrangements, a stage might have been reached at which the notes were accepted with reluctance in payment for deliveries. That stage may yet be reached, if hostilities continue much longer. Even so, it would not lead to the termination of the hostilities, for in territories under the Government's control the military authorities will certainly

be able to commandeer everything the armies need, even without payment.

The occupation of Shanghai and other leading commercial and financial centres cut off the interior from its normal supply of credit. To overcome this difficulty, at an early stage of the war arrangements were made in a number of centres in the interior that Government-controlled local banks should finance indispensable enterprise which had formerly depended on Shanghai or some other centre. Thanks to the comparatively primitive state of the Chinese economic system in by far the greater part of the country the complications which would arise in a modern community severed from its financial centres were in themselves not intolerable.

(4) Sale of Silver to the United States

The external purchases of the Nanking Government, and such other imports as found their way to the Chinese territory under its control, were financed mainly through the export of silver. Large consignments of silver found their way from China to London and thence to the United States Treasury. The main reason why the silver was taken first to London was that it had to be refined before it was accepted as good delivery by the United States authorities, and it was technically more convenient to make use of the London refining facilities than to have all the metal refined in the United States. The American refineries were in any case engaged to the limit of their capacity in refining silver shipped from abroad by arbitrageurs.

Notwithstanding the rumours to the contrary, no external credits or loans were granted to the Nanking Government, though it is probable that large quantities of war material were delivered by Russia on a credit basis or entirely free of charge. Apart from this, the Chinese Government had to pay cash for its purchases of war material abroad. Although Mr. Kung, on the occasion of his European visit, announced the conclusion of a number of credits and loans, none of these operations is believed to have actually materialised. He left a bad impression by giving publicity to transactions which were in an initial stage of negotiation. On the whole it is therefore correct to say that China is fighting the war without any external financial assistance.

(5) Stability of the Yen

The maintenance of the yen at its level of 1*s.* 2*d.* was achieved partly by the reinforcement of import restrictions and exchange restrictions, and partly by the export of large shipments of gold to the United States. Even before the beginning of the war, substantial amounts of gold had been shipped by the Bank of Japan to San Francisco, and there were further shipments for a time after the outbreak of the hostilities. Most of the proceeds were converted into sterling, because Japanese import trade is financed mainly through London. Efforts were made to speed up gold production, especially in Chosen. There was no truth in the reports that were circulated from time to time, that Japan intended to abandon the gold standard altogether. The export of gold was the result of sheer necessity, and not of any deliberate change in monetary principles or policy.

In 1903 the Russo-Japanese war cost Japan some 2 milliard yen. Half of it had to be raised abroad. The amount spent during the first three months of the present war was considerably in excess of the amount spent on the whole Russo-Japanese war. No part of it was raised abroad, for the simple reason that the financial markets were closed for new Japanese loans or credits. The countries which, without being politically in sympathy with the Japanese policy of expansion, were desirous of encouraging it for a time, namely Germany and Italy, were themselves in need of foreign exchange, and while it is conceivable that they may have supplied Japan as well as China with war material on a credit basis, they could do nothing to meet her raw-material requirements or to grant cash loans. In London and New York, the existing commercial credits were carried on, but their amount was negligible.

(6) No Immediate Difficulties

It should be remembered, however, that Japan is not engaging her full strength and resources in the Chinese war. Large as the expeditionary army is, the economic and financial strain which it causes is moderate compared with the immense strain on the resources of the nations which participated in the war of 1914–18, when all the man-power available was mobilised. The situation is somewhat similar to that of Italy during the Abyssinian campaign, when only a relatively small part of the country's resources had to be used for the pursuit of hostilities. Thus it is that the effect of the Sino-

Japanese war upon the Japanese trade balance is not nearly so pronounced as was expected. Since the flight of capital was brought virtually to a standstill, the maintenance of the yen has not up to the time of writing presented an unduly difficult problem.

Nor was the problem of financing the war impossible of solution. By far the larger part of the expenditure was in Japan itself. While in 1903 it had been necessary to finance the Russo-Japanese war to a large degree by money borrowed abroad, in the meantime the Japanese capital market had developed considerably. The growth of Japanese bank deposits and other forms of fictitious wealth showed that there were ample financial resources available for internal loans. It should be borne in mind that for some years money has been plentiful in Japan and interest rates, though higher than in Great Britain or the United States, have declined to a relatively low level. Up to the time of writing the Government has been successful in raising all the internal loans it requires, and the extent to which the war has produced currency inflation is negligible. It is true that the note circulation has been increasing. Part of the expansion of notes was, however, due to the issue of Bank of Chosen notes, with which the Japanese troops in North China are paid. These notes are issued against Bank of Japan notes. Allowing for this the pace of the increase in the active circulation of Bank of Japan notes has not been much more pronounced than it was during the last few years before the beginning of the war. The absence of inflation is indicated by the fact that in accordance with the world trend the index number of wholesale prices declined slightly during the autumn of 1937.

(7) Effect of Prolonged War

Needless to say, it is inevitable that the war, if prolonged, should lead to inflation. Owing to the vast size of the Chinese territory that has come under Japanese control, it will be necessary to keep a large army of occupation, whose expenses will swell the cost of the actual hostilities. Provided that the war is confined to China, there is no reason to suppose, however, that inflation will get out of control. The Government is almost certain to be able to finance by far the largest part of the expenditure by means of internal loans. The process described in the chapter on Germany, by which the money spent by the Government eventually returns to the Government and can be spent over and over again, also

operates in Japan. Even though Japan is not a totalitarian State, a high degree of economic discipline exists. If by any chance voluntary subscriptions to a Government loan were inadequate to cover requirements, there can be no doubt that coercion similar to that applied in Germany and Italy would produce the desired effect. The banks are bound to do their best to co-operate with the Government in financing the war, in spite of the fact that at first they were strongly opposed to it. Once, however, the country was engaged in war, the banks had no choice but to give the Government their full support.

Nor is shortage of exchange in Japan likely to lead to an early termination of the Sino-Japanese war. Imports can be reduced further, if necessary, and export subsidies would enable Japanese trade to recover many lost markets. Alternatively the yen might eventually be allowed to depreciate, in which case Japan's exporting capacity would increase automatically. In case of a prolonged war, Japan may be able to organise trade to her advantage with the occupied regions of China. Moreover, Japan has not even begun to apply the system of exchange clearing and compensation agreements, which have worked with such amazing results in the case of Germany and, to a less extent, Italy. It should be remembered that as far as food is concerned, Japan is almost self-supporting, owing to the modesty of the requirements of her population, and to the supplies obtained from Chosen and Taiwan. It is only raw-material imports that are indispensable.

(8) Futility of Sanctions

Nor is there any likelihood of Japan's being forced to terminate hostilities by means of the application of a widespread boycott or sanctions. All the agitation in favour of boycotting Japanese goods have produced only very modest results so far, and no voluntary action is likely to make any fundamental difference to the volume of Japanese exports. As for sanctions, after their disastrous failure in the case of Italy there is but little inclination on the part of most countries to agree to their application against Japan. At the beginning of the war there was some agitation in various countries. The same arguments which had been used in favour of the application of sanctions against Italy were now put forward by the same people, who demanded their application against Japan, and claimed that sanctions could not fail to force

Japan to stop the war. Apparently economists and Left Wing journalists learnt nothing from the Italian experience; and yet the chances of the successful application of sanctions against Japan are even weaker than they were in the case of Italy. As I have already stated, in the matter of food Japan is nearly self-sufficient—certainly more so than Italy—so that her population could not be starved into submission. As for raw materials, she could always find sellers so long as she was able to pay cash. Nor is it likely that a large number of Governments would agree to exclude Japanese exports. Or, if they did agree, in practice they would circumvent the sanctions to an even greater degree than they did those applied against Italy.

Admittedly, Japan has one weak point, and that is her lack of oil supplies. If it were possible to stop the sales of oil to Japan, this would certainly bring the war to an early end. The question is, however, what kind of a conclusion would it be? The chances are that, threatened with the depletion of oil supplies, the Japanese army would resort to the use of the deadliest of weapons, which it has not hitherto applied, namely poison gas. If the use of poison gas produced such a demoralising effect in sparsely-populated Abyssinia, its effect in densely populated China is horrible to contemplate. The victims of air-raids in an over-populated city would then be numbered in hundreds of thousands, not in hundreds or thousands. Driven to desperation by the prospect of defeat through an embargo on oil, Japan would be almost certain to resort to this horrible method of warfare. It seems probable that in the case of Abyssinia it was the adoption of sanctions that induced Italy to employ poison gas in order to bring the war to a speedy end before sanctions began to produce their effect. Japan, too, would probably respond to sanctions by an effort to terrorise China into submission. The result of the application of sanctions would thus be to increase the horrors of the war.

This consideration would not, of course, influence those fanatics to whom the satisfaction of "doing something" to punish the aggressor is more important than the lives of hundreds of thousands, or millions, of innocent victims. They would demand sanctions even if they were certain that their application would lead to an unprecedented increase of suffering by the people whom they were claiming to help. Fortunately most Governments are more realistically minded than these doctrinaires of collective security. Judging by the negative

result of the Brussels Conference, the Governments must have realised the futility of sanctions as a means of checking aggression. It is indeed absurd to imagine that a country whose population is so extremely patriotic as that of Japan could be forced by economic measures to accept what it would regard as humiliating terms. The second failure of collective action would certainly mean an end to the League of Nations; it might be even more damaging to the prestige of Great Britain and other democratic countries than the failure of sanctions against Italy. The powers concerned in the fate of China must make up their minds whether they are prepared to fight Japan or not. If, as is probable, the answer is in the negative, then the wisest course is to avoid driving her to extremes by the application of economic sanctions.

PART VI

THE SETBACK IN TRADE

CHAPTER XXVI

AFTERMATH OF THE GOLD SCARE

(1) Reflationary Trend Checked

During 1937 in China, Japan and Spain, war finance accentuated considerably the reflationary forces at work. In most other countries, rearmament provided a powerful stimulus to reflation. Notwithstanding this, the world-wide trend of reflation, which had become accentuated after the devaluation of the Gold Bloc currencies in 1936, came to a sudden halt during the second quarter of 1937, and after some months of hesitation became definitely reversed during the late summer and the autumn. Although many factors shared the responsibility for bringing about this setback, there can be no doubt that the gold scare was by far the most important amongst them.

We saw in Part II of this book that the immediate effect of fears of a cut in the price of gold was a heavy slump on the Stock Exchanges and in the commodity markets. This slump inflicted substantial losses upon a number of speculators and reduced the value of the assets of investors. To that extent it tended to discourage spending. Since, however, speculation was not on a scale comparable to that of 1929, the number of those directly affected was relatively small. Nor did most investors take an unduly gloomy view of the prospects once the gold scare was over. Since there was as yet no sign of a trade recession, they were confident that, no matter what might happen to the capital value of their investments, they would continue to receive dividends on the same scale. The actual reduction in the volume of spendings by consumers during and immediately after the gold scare was therefore relatively moderate. It did not materially affect employment figures in Great Britain or the United States.

(2) Faith in Upward Movement Broken

The gold scare came to an end months before its effects upon trade began to manifest themselves. The nightmare was over by July, and the world sighed with relief at having

escaped from the gravest danger which had threatened it in the economic sphere since 1931. Although many people were afraid that the scare might return on a more modest scale, on the whole the public felt that they could breathe freely. Until March 1937 it had been generally taken for granted that the rise in commodities and securities would continue for years. Although much was said about the possibility of the boom giving way to depression in accordance with the classical rules of the trade cycle, few people as yet paid attention to this gloomy prophecy. The gold scare, however, introduced an element of doubt. Faith in the continued upward trend was broken.

The fundamental position was nevertheless exactly the same as before the gold scare. The rearmament race continued unabated. In fact, in Great Britain, at any rate, it was only beginning to assume considerable dimensions. The large and increasing gold stocks provided a basis for a very considerable degree of inflation. In fact, the controversy over the gold scare drew attention to the existence of this potential inflation, the realisation of which should in the long run have acted as a bull point. As a result of the wide publicity given to the arguments in favour of a cut in the price of gold, the public must have become aware by July that owing to a huge gold surplus there was ample possibility of monetary expansion leading to a rise in prices and profits. Since it had become obvious that the gold situation would not be adjusted by means of a cut in the price of gold, the only possible way in which it could be adjusted was through a rise in commodity prices and in the volume of trade.

(3) Depression-mongering Economists and Stock Exchange Tipsters

The public found it difficult, however, to forget the reverse experienced during the second quarter of 1937. Economists and Stock Exchange tipsters did their best to stimulate pessimism among the public. Talk about the cyclic depression was revived. We were told over and over again that it was in accordance with the Laws of Nature that there should be a major depression at least once every seven years. The last depression began in 1929, and therefore another cyclic depression was just about due. The conception of the business cycle has taken deep root in the mind of a public brought up largely on the experience of the nineteenth century. Few people realise that factors such as the rearmament race or the

potential inflation through the increase of the gold stock are apt to cut across the trade cycle. The setback during the gold scare came to be regarded as an indication that the upward movement was coming, or had come, to an end.

Pseudo-scientific and frankly unscientific Stock Exchange tipsters also did their utmost to accentuate the feeling that a major recession was imminent. The degree to which these tipsters secured a hold over the market was remarkable. Their number was considerable, and each had a more or less substantial following. It is one of the characteristics of human nature in general and of the nature of speculators and investors in particular, that it likes to be led. If anyone states a view with sufficient determination and gives every evidence that he knows his mind, he is almost certain to find a number of followers, whether he be the founder of a new religion, a dictator or a Stock Exchange tipster. In the majority of instances the advice given by these tipsters merely confirms views already held consciously or subconsciously by speculators or investors. One wonders why so many people are willing to pay subscriptions or fees for advice, when they eventually do just what they intended to in the first place. The explanation is that people like to shift the responsibility for the final decision on to someone else, and derive encouragement from the thought that instead of acting on their own undependable judgment, they had followed Mr. So-and-So, who is a recognised authority on the subject. If the advice goes wrong, they comfort themselves with the thought that they acted on the best advice obtainable, just as the relatives of the patient who dies on the operating table comfort themselves by saying that they could do no more than engage the most expensive surgeon.

(4) Barometer spoils the Weather

Since the preachings of economists about the imminence of a cyclic slump prepared the minds of large sections of the public for such a slump, the indications given in the same sense by Dow-Jones and other investment-advising services fell on fertile soil. From August onward a definite downward trend developed in Wall Street. Everybody talked about the imminence of a business recession, and since there were so many people who believed in the infallibility of Dow-Jones and other similar services, the mere fact that those prophets anticipated a fall in securities led to a sufficient volume of selling pressure to bring about the fall, thus justifying their prophecies. Even though at first the forecasts had no material

justification, within a brief space of time they created their own justification. The barometer had succeeded in spoiling the weather.

The downward trend in Wall Street accentuated the prevailing pessimism regarding trade prospects. The result was a substantial falling off of orders in the United States. This was to a large degree due to the fact that under the influence of rising prices at the beginning of the year, most manufacturers were overstocked with raw material, and most dealers with manufactures. Even consumers were inclined to place orders in excess of immediate requirements, in anticipation of a further rise in prices. The whole economic system of the United States and, to a greater or less degree, of the larger part of the world, was based on the assumption that the rising trend in commodity prices would continue for a long time. The gold scare and the subsequent setback in Wall Street destroyed this faith, and brought about a severe reaction. Manufacturers and dealers decided to let their stocks decline, and consumers decided to hold back their orders. There was a sharp decline in the demand for raw materials, resulting in a slump in basic commodity prices. Admittedly, other factors such as the record cotton crop also contributed to the fall in individual commodities. By far the most important factor, however, was the desire to use up surplus stocks.

(5) Comparison with 1929

By September the slump in commodities and the decline in industrial activity in the United States was in full swing. The figures of the decline in the activity of the steel and motor-car industries were really alarming, and, coupled with the slump in commodities and in Wall Street, further accentuated the wave of pessimism. By the turn of the quarter, the world was caught in the vicious circle of deflation. Pessimism regarding the prospects resulted in a fall in Wall Street; the fall in Wall Street resulted in contraction in the demand for commodities; the contraction in the demand for commodities resulted in the accentuation of the pessimism; this in turn brought about a further fall in Wall Street, and so on. American temperament was always inclined towards exaggeration, and it became fashionable to talk about a repetition of the experience of 1929. As far as the material factors were concerned, nevertheless, the situation was fundamentally different from that of eight years before. In 1929 the scarcity of gold provided fundamental justification for a slump. The

world's gold stock was too small to support the prevailing level of prices. In the meantime, however, currency devaluation and the increase of output had resulted in a spectacular increase in the world's monetary gold stock. Allowing for this increase, the price level was now much too low and the situation called for adjustment by a drastic rise in commodity prices. Nor was any overproduction in evidence. In 1929, stocks of several staple agricultural products, such as wheat, were far in excess of requirements. By 1937 the surplus stocks of wheat and most other commodities had been completely liquidated. In 1929 there was a high degree of underconsumption as a result of profit inflation and the maldistribution of incomes. In 1937 the increase of wages in the United States and other countries had reduced the extent of profit inflation, and the distribution of incomes was probably better than eight years before. Above all, between 1929 and 1937 the value of the monetary unit was scaled down by about 40 per cent. Thus the price level which may have been too high in 1929 would have been distinctly too low in 1937, although in fact the price of most commodities had not even approached their 1929 level. So much for the difference in the fundamental situation.

From a technical point of view, the situation was incomparably sounder in 1937 than it had been eight years earlier. In 1929 speculation had been largely financed by brokers' loans, the amount of which rose to fantastic figures. Such was the demand for accommodation that borrowers were prepared to pay interest of 10 per cent and more. In 1937, on the other hand, the amount of brokers' loans was moderate, and interest rates were very low. There was no difficulty whatsoever in obtaining accommodation within the limits of the margin requirements imposed on the market by legislation. A much more important difference was that while in 1929 yields had declined to an abnormally low figure, during the second half of 1937 they became exceptionally high. To put it in a nutshell, while in 1929 the rate on brokers' loans was 10 per cent and the yield on the stocks financed by those loans was 1 per cent, in 1937 the rate on brokers' loans was 1 per cent and the yield on good-class industrial equities was 10 per cent.

(6) Predominant Importance of Psychological Factor

The experience of August–October 1937 in the United States provided a useful reminder of the predominant importance of the psychological factor. It was a severe blow to the teachings

of those economists who believed that cheap money could cure all evils. For years those economists were triumphant. They were in a position to point out that the reduction of money rates in Great Britain, the United States and other countries brought about a revival of trade, while countries where money rates were maintained at a high level continued to suffer from depression. The truth is, that although cheap and plentiful money unquestionably removed one of the obstacles to trade recovery, nevertheless in itself it could not bring about recovery to any substantial extent. As the American experience proved, in face of adverse psychological factors it could not even maintain the recovery which had been achieved.

If the United States authorities ever considered the idea of managing the business cycle with the aid of gold scares, the experience of 1937 must have taught them that it is dangerous to play with fire. It is easier to bring about a setback by means of a gold scare than to check the movement thus provoked when it is inclined to go too far. Admittedly, in all probability the theory according to which the gold scare was deliberately engineered in order to check an unwanted boom was unfounded. Nevertheless, President Roosevelt bears a large share of the responsibility for the wave of pessimism that developed in the autumn of 1937, since it was his anti-boom statement of March more than anything else that gave rise to the gold scare. Thus the origin of the subsequent slump was President Roosevelt's premature and unjustified fears of an excessive boom. Had he but realised what far-reaching consequences his statement would produce, he would undoubtedly have preferred to allow the rise in commodity prices to proceed unhampered. After all, when he set out to check the rise, the price level was still far below its figure of 1926, which had been his declared goal in earlier years. A further rise in commodity prices far above the level attained during the first quarter of 1937 would have been advantageous in that it would have contributed to the reduction of the excessive burden of indebtedness. But even if such a rise had been disadvantageous, it would have been a lesser evil than the setback which President Roosevelt brought about in his all too successful attempt to check the rise.

CHAPTER XXVII

THE JITTERS

(1) Unwarranted Slump creates its own Justification

Once the recession had set in, there was no lack of accessory factors tending to accentuate it. The predominant majority of the public in the United States and, to a less extent, in other countries, had made up its mind that things were going to deteriorate. This being so, no matter what happened in no matter what direction, it was interpreted as an additional cause for pessimism. Bear points lurked in every corner, and to the growing number of genuine bear points a host of imaginary ones were added. As President Roosevelt rightly remarked, the markets had the "jitters".

A Stock Exchange slump, however unreasonable it may be at first, is apt to create its own justification if it proceeds far enough. The fall in securities inflicts losses on speculative holders and thus creates weak positions. It necessitates forced sales by banks, as, if the fall has been sufficiently substantial, it threatens to exhaust margins. Such forced sales are apt to accentuate the downward movement considerably, and thereby create new weak positions, new forced sales and a further accentuation of the slump. This is what was happening on a large scale in September and October 1937.

(2) Mischievous Rumours

It was inevitable that the losses sustained by speculators, and the forced liquidations carried out by banks, should give rise to a crop of rumours about the position of the banks themselves. In the predominant majority of instances, these rumours were entirely without justification. Banks were much more careful in financing speculation than they had been in 1929, and even though the suddenness of the slump may have inflicted substantial losses upon them, these losses could not have been on a sufficient scale in the case of any of the banks of importance to endanger their solvency. Moreover, the process of the elimination of the unfit in the world of banking during 1931–3, painful as it was, proved beneficial in the long

run, since most of those banks which survived the crisis were strong. Having had a number of profitable years, during which large amounts of claims which had been written off as bad debts had become good, the banks were strong enough to face this setback. Amidst the general atmosphere of pessimism, especially in London, during October, many people found it, however, difficult to believe that this was so. A series of fantastic rumours appeared about the alleged heavy losses and difficulties of leading banking houses, and even of joint stock banks. These rumours were deliberately fostered by the French Communist Press, which displayed an amazing degree of irresponsibility. After all, nobody but the Fascist Governments of Berlin and Rome stood to benefit by a major financial crisis in London. Fortunately the rumours died down fairly soon, but while they lasted they did a considerable amount of damage.

(3) War Scares

Another source of bear points was the aggravation of the international political tension. The inconsistency of market mentality cannot be exemplified better than by the fact that war scares in Europe resulted in a slump in industrial shares, not only in London but even in New York. Earlier in the year, the bare possibility of an agreement for the limitation of armaments was sufficient to accentuate the fall caused by the gold scare and the British budget scare. Realising the extent to which continued prosperity depended upon the rearmament race, brokers and directors of Trust companies shuddered to think what might happen when—to use the words of a Stock Exchange cynic—" peace broke out ". Peace scares added to the effect of the other scares prevailing during the second quarter of the year. Whatever view we may hold of the moral aspects of the Stock Exchange attitude towards a much-desired improvement in the international political outlook, there can be no doubt that from a purely financial point of view it was a reasonable attitude. This being so, it would have been equally reasonable if the elimination of the possibility of a disarmament agreement and the aggravation of the international political outlook had acted as a powerful bull point.

Unfortunately, as the year 1937 proceeded, it became increasingly obvious that, taking a long view, international relations could only go from bad to worse. It was equally obvious that the rearmament race was bound to proceed for

many years at an increasing pace. This meant that industrial firms engaged in rearmament work were sure to be able to work to the limit of their capacity for many years to come, and that indirectly most other branches of industry would also benefit by the constant flow of rearmament orders. Notwithstanding this, whenever some new development in the international political situation made rearmament appear more urgent and imperative, the response of the Stock Exchange was exactly the opposite to what might logically have been expected. The war scares that followed one another in close succession as a result of the Sino-Japanese conflict, the Mediterranean tension and the periodic outbursts of Hitler and his lieutenants provided a setback in industrial shares, including rearmament shares.

(4) Effect on Wall Street

As far as the London Stock Exchange was concerned, this may to some extent have been justified by fears that British industrial undertakings might suffer through air raids in case of war. The same consideration did not, however, exist for American industries. The experience of the last war amply showed the effect of a war in Europe upon American industrial earnings. Even in the unlikely event of the United States herself being involved in an armed conflict, American industrial plant is safely removed from the bombing range of any potential opponent. Notwithstanding this, Wall Street was, if anything, more sensitive towards war scares than any European Stock Exchange. The aggravation of the Italo-British relations resulted in a heavier slump in Wall Street than in Throgmorton Street. It is impossible to explain this on any rational basis. The American public was simply determined to find bear points at all costs. It regarded war scares as bear points, but it would also have regarded "peace scares" as bear points. It regarded President Roosevelt's reflationary measures as bear points, but had the President adopted deflationary measures, or had he even refrained from adopting reflationary measures, his attitude would nevertheless have caused a fall in Wall Street. Wall Street in a bearish mood is apt to assume the Russian characteristic of being determined to be unhappy.

(5) Liquidity-Preference

As a result of this widespread feeling of uncertainty, investors were completely at a loss to know what to do with their capital.

They were anxious to get out of equities in anticipation of a prolonged trade depression. This flight from equities was not by any means confined to Wall Street. It spread over the London Stock Exchange, where industrial shares had become distinctly overvalued during the earlier part of the year as a result of the anticipation of a boom and of the influx of refugee funds. The yield of about 4 per cent on an ordinary share of a good-class industrial company was distinctly on the low side at a time when the fall in the gilt-edged market brought the yield on Government securities to the vicinity of 3½ per cent. Once faith in the continued boom was broken, it was inevitable that there should be liquidations tending to bring down industrial shares from their overvalued level. Even though that level is likely to justify itself in the long run, few investors think in terms of the next five or ten years. They are more concerned with the next dividend.

The jitters resulted in a high degree of liquidity-preference on the part of investors, speculators and business men in general. They wanted to keep their capital in a liquid form, partly for fear of a crisis necessitating liquid resources, and partly because of their conviction that stocks and commodities were bound to go lower. The effect of this liquidity-preference was that it gave a new lease of life to the cheap-money era. While at the beginning of 1937 it appeared as though the days of the cheap-money era were numbered, at the end of that year even the most fervent advocates of dear money had to realise that they would have to put up with cheap money for a long time to come. Apart altogether from the effect of liquidity-preference upon the volume of short-term funds, there was also a demand for Government securities, especially in Great Britain. The result was a recovery in the gilt-edged market, in sharp contrast with the general downward trend of industrial markets. This recovery enabled the Government to unload the undigested part of the first instalment of the National Defence loan.

Another reason why the setback in trade and on the Stock Exchange led to the anticipation of continued cheap money was that in the circumstances neither the British nor the United States Government could possibly be expected to abandon its cheap-money policy. While in face of a persistent boom they might possibly have resorted to dearer money, since the boom was over for the time being, talk about a higher bank rate subsided completely. In fact, as we shall see in the next chapter, the British Government,

and even more the United States Government, resorted to measures of monetary expansion.

(6) Repercussions in Great Britain

It was hoped in Government circles that Great Britain would be spared the trade recession, which was regarded as a purely American affair. It was argued that as a result of the adoption of protection after 1931, and even more as a result of the conclusion of the Ottowa agreement, Great Britain was less dependent upon economic fluctuations abroad than she had been in 1929. To some extent this was undoubtedly true. Nevertheless, the psychological factor is strong enough to affect trade everywhere, at any rate in every country under a liberal economic system. The only countries which are largely immune from the international psychological factor are the totalitarian States, whether Communist or Fascist. The liberal countries keep their economic freedom only by sacrificing their economic stability.

As a result of the jitters there was a distinct falling-off of orders also in Great Britain, and in November the unemployment figures showed an increase of more than 100,000, in spite of the fact that the foreign trade figures continued to expand. The stock phrase, that has been heard so often during the last few years, that " there could be no true prosperity unless the expansion of home trade was accompanied by the expansion of foreign trade", sounded somewhat foolish in the light of the British experience towards the end of 1937.

One of the results of the jitters was the increased restlessness of refugee funds. Neither the dollar nor sterling was any longer considered safe enough by the owners of such funds. There was a revival of gold hoarding. Foreign balances were shifted nervously from centre to centre. Some of them even found their way back to their owners' countries on the ground that if there was a risk both at home and abroad, it was just as well to take the risk at home.

CHAPTER XXVIII

PRESIDENT ROOSEVELT'S DILEMMA

(1) De-sterilisation of Gold

As soon as the indications of a trade recession became noticeable, the Washington Administration adopted measures aiming at counteracting the downward trend. In the first instance, President Roosevelt reverted to his reflationary monetary policy. Before the recession became evident, measures aiming at making money easier had already been taken in order to meet the increased demand for credit which was anticipated for the autumn as a result of the exceptionally large cotton crop. In August the Chicago and Atlanta bank rates were reduced to 1½ per cent, and shortly after the New York bank rate was reduced to the unprecedented figure of 1 per cent. Subsequently the authorities undertook open market operations, increasing the volume of credit by buying securities. In addition, the Administration decided to de-sterilise $300 million of gold from the Inactive Gold Fund.

This latter step was of considerable significance from the point of view of gold prospects. It indicated the way in which the unwanted gold surplus of the United States would gradually be absorbed as a result of the increased American credit requirements. The very fact that the surplus which had formerly been a target for attacks had been used for the requirements of monetary policy tended to disarm anti-gold agitation in the United States. Indeed, once the de-sterilisation had been carried out, hardly anything was heard about the necessity of limiting American gold purchases.

While the act of de-sterilisation was useful from this point of view, it produced no actual result so far as the American trade recession was concerned. It is true that the de-sterilisation brought about a corresponding increase of the excess reserves of the member banks of the Federal Reserve system, but this in itself did not create an increased demand for credit. Before the de-sterilisation, the credit resources were already in excess of requirements. The increased demand for credit which was anticipated for the autumn in connection with

the crop movements did not materialise, because, as the recession proceeded the demand for commercial credit accommodation declined. The experience of de-sterilisation once more confirmed the fact, so often overlooked by expansionist Governments, that the mere existence of ample credit resources does not in itself induce trade to make use of these resources if, rightly or wrongly, merchants and manufacturers assume that they will be unable to make profitable use of the credit. Once more the predominant importance of the psychological factor became evident. The attempt of the Administration to reflate by means of an easy-money policy resulted in complete failure owing to the prevailing feeling of pessimism.

(2) Wall Street Margin Requirements Relaxed

It was comparatively easy for President Roosevelt to revert to his cheap-money policy, which was, after all, the basis of his policy between 1933 and 1936. It was much more difficult for him to decide upon measures which were in conflict with the basic principles of his policy. Nevertheless, a first step in that direction was made in October, when it was decided to relax the stringent margin requirements imposed upon the Stock Exchange. These margin requirements were introduced in order to prevent a boom. Whether they could produce that effect or not was never proved. It became evident, however, during the recession of 1937 that these margin requirements were very effective in preventing recovery after a slump. They discouraged bull speculation from taking a hand when, after a heavy drop in equities, there appeared to be a good opportunity to make a profit.

What was much more important, since according to the regulations brokers had to insist upon a 45 per cent margin, in the majority of instances they did not insist upon very wide margins beyond the legal minimum.

After all, it did not seem likely that there would be falls in excess of 45 per cent. As a result, even relatively small falls brought margins below the figure of the legal minimum, necessitating the provision of additional margins, or forced selling. The Administration, realising that its stringent margin requirements had proved to be a boomerang, reluctantly decided to relax them. It required some effort to reach this decision, since it amounted to capitulating to Wall Street. Even this measure failed, however, to produce the desired effect. Evidently something much more drastic was needed in order to restore optimism.

(3) Business Men Hit Back

As the recession proceeded, the idea that it was due to President Roosevelt's anti-capitalist measures gained ground. At first this theory had very little justification. After all, ever since his advent to office, President Roosevelt had been introducing measures which antagonised the business world. There was nothing fundamentally new in any of the measures he passed or planned in 1937. Even his Wages and Hours Bill, which aroused widespread protests in the business world, was merely an attempt to resuscitate his New Deal legislation, killed by a series of Supreme Court decisions. Since the original New Deal legislation did not prevent a trade recovery, there was no reason why an attempt to resuscitate that legislation in a modified form should even check recovery, let alone produce a recession.

By 1937, however, American business men had regained much of their confidence in their own power. Between 1933 and 1935 they had meekly submitted to the series of blows dealt to them by the Roosevelt Administration. This was largely due to the demoralising effect of the prolonged trade depression and the series of banking crises which had made the business world dependent for its existence on the Government's support. With the progress of recovery, however, the bogy of insolvency disappeared and the extent of the business world's dependence on Government support declined. Having consolidated their financial position, business men set themselves the task of recovering their lost political power. The trade recession of 1937 provided an excellent opportunity to attain this end.

(4) The "Rich Men's Revolt"

American business men received encouragement from the success of the Rich Men's Revolt in Great Britain and France. We saw in Chapter XVII that Mr. Chamberlain, notwithstanding his overwhelming majority in the House of Commons, had to capitulate to the Rich Men's Revolt and scrap his National Defence Contribution scheme. We also saw, in Chapters X and XI, that M. Blum, notwithstanding his overwhelming majority in Parliament, had to agree to call a halt in his social reform programme in March, and that subsequently he had to give way to a moderate Government which had the qualified approval of the "200 families". If the Rich Men's Revolt was successful in Great Britain and France,

how much more chance it had to succeed in the United States, where Big Business had always had a much stronger political position than in either of the other countries!

Accordingly, the American business world set about defeating the President's anti-capitalist policy. By the autumn of 1937 the Rich Men's Revolt in the United States was in full swing. This does not mean that there was a conspiracy between business men to act in such a sense as to embarrass the Administration. There had been no such conspiracy either in Great Britain or in France. The interests of the prospective victims of the National Defence Contribution were identical, and the victims acted in the same way even without any co-ordination of their activities. The interests of the French wealthy classes in face of the anti-capitalist policy of M. Blum were identical, and there was no need for a conspiracy to induce the wealthy to retaliate. In the same way, even in the absence of any actual agreement between wide classes of American business men and investors, during the autumn of 1937 they all acted in a sense calculated to embarrass President Roosevelt's administration. They got it into their heads that the recession was entirely due to President Roosevelt's anti-capitalist measures. A parallel was drawn between M. Blum's 40-hour week and President Roosevelt's Wages and Hours Bill. It was stated again and again that should that bill become law the effect on American trade would be as disastrous as the 40-hour week had been on French trade. The widespread anticipation of its disastrous consequences was in itself sufficient to inspire pessimism among investors, and to induce business men to reduce their stocks.

Thus while originally the theory that the business recession was due to President Roosevelt's anti-capitalist measures was not true, it subsequently became only too true. As the author of *Alice in Wonderland* remarked in *The Hunting of the Snark*, if a thing is said three times it becomes true. By the middle of the autumn everybody was convinced that nothing short of a drastic revision of President Roosevelt's anti-capitalist legislation could possibly turn the tide. And since everybody was convinced that this was so, it was well on its way towards becoming true.

(5) President Roosevelt's Key to the Situation

There could be no doubt that President Roosevelt held the key to the situation. Ever since his advent to office in 1933 he had occupied an outstanding position among the statesmen

capable of influencing the economic destinies of the world. It was his ruthless reflationary policy that turned the tide. It was largely his departure from his reflationary principles that brought about the gold scare which reversed the tide. Official quarters, bankers, newspapers, investors and speculators over the five continents have become accustomed to looking towards Washington, hoping or fearing—as the case may be—that President Roosevelt may take some action. A casual remark by him is sufficient to turn the tide of the exchanges, of gold and silver, of stocks and shares or of commodities. His power for good and evil has been amply evident during the past five years. Never, however, had it been quite so evident as it was during the autumn of 1937.

Nothing which the British Government or any other Government could possibly do would have made a fundamental difference to the downward trend at that time in progress. On the other hand, President Roosevelt was in a position at any moment to turn the tide. A gesture from him would have been sufficient to convert the gloomy faces of Wall Street and Throgmorton Street into smiling faces. He possessed the magic power to induce millions of people, not only in his own country but also in countries thousands of miles from the borders of the United States, to spend freely once more, instead of retrenching for fear of another depression. A word from him would have been sufficient to restore to employment millions of hands in the United States and elsewhere, and to restore peace of mind to many millions more who were trembling for their jobs.

(6) Need for Sacrificing New Deal Legislation

All this, and more, could have been achieved if only President Roosevelt had wanted to achieve it strongly enough to be prepared to make some sacrifices for it. He would have had to sacrifice, or at any rate relax, some of the principles which had been guiding him ever since he assumed office. We are all apt to jibe at the instability of President Roosevelt's character, and at the ease with which he adopts policies and drops them again as a matter of opportunism. As a matter of fact, in questions which to him are fundamental he has proved remarkably steadfast. His New Deal legislation is to him a religion to which he adheres with the fanatical dogmatism of the social reformer. He believes that in forcing through his New Deal legislation in face of the opposition of business interests, he will be able to improve

the lot of the vast American working classes. He considers it his vocation in life to bring relief at all costs to that one-third of the American population which, notwithstanding the high average standard of living in the United States, is still ill-fed and badly clad.

It was with this object in view that he passed the various Acts, each one of which made him the best-hated man in Wall Street and among industrialists. He had to retreat at times, when he was defeated by the Supreme Court, or when Congress was unwilling to follow him. Nevertheless, whenever he retreated for tactical reasons, he took the first opportunity to advance again in the path which he had determined to follow.

In order that the relapse should be checked and the trade revival resumed, it appeared absolutely essential that President Roosevelt should relinquish, of his own free will, some of the gains which he had achieved for the poor at the expense of the rich. It would be idle to dwell on the rights and wrongs of that course. There are situations in which both points of view are right, or both wrong. This was certainly one of them. The working-classes stood to benefit by his Wages and Hours Bill, and by his attitude to capital and labour in general, only if trade was prosperous. Otherwise they were bound to suffer, and it would have been small comfort to them to see the rich suffering too.

(7) Concessions to Business and Capital

There was no hope of a turn for the better unless President Roosevelt was prepared to abandon, or at any rate materially relax, his Wages and Hours Bill; unless he was prepared to treat public utility companies and railroads more leniently; unless he was prepared to relax to some extent his "soak the rich" policy. The question was not the ethical one of whether it was right or wrong to proceed in that direction, but an essentially practical one. President Roosevelt had tried all other means and none of them had succeeded. He reverted to his reflationary cheap money policy, lowering the New York bank rate to 1 per cent and reversing the process of gold sterilisation. He relaxed the drastic regulations which were strangling Wall Street, having discovered that these regulations, whether they were effective or not in regulating a boom, were certainly very effective in accentuating a slump. He announced his intention of embarking upon vast public works. It was even suggested that his Administration resorted

to the tactics of engineering a dollar scare so as to encourage a rise in commodities and equities as a result of the anticipation of a new devaluation of the dollar. All this had no lasting result. From time to time the downward trend appeared to have been checked; occasionally there was even a passing recovery. Taking the trend as a whole, however, it continued to point downward.

To some extent President Roosevelt yielded to the demand for a revision of his policy. He agreed to an increase of railroad tariffs, though not nearly to a sufficient extent to make up for the rise in costs. He agreed to adopt a less rigidly hostile attitude towards public utility companies. He even foreshadowed closer collaboration with private capital and enterprise in his gigantic housing scheme. The Administration, instead of undertaking to finance and execute the whole scheme, was to supply only a small part of the milliards required, just sufficient to provide adequate encouragement to private capital and enterprise to induce them to undertake the bulk of the financing and execution of the scheme. A revision of the system of taxation was also foreshadowed. Twelve months before, this concession would have filled the hearts of rich men and business men with delight. In the autumn of 1937 it was not nearly enough. Having realised the strength of their position, the business men wanted to achieve a thoroughgoing victory.

(8) Half-hearted Gestures

Although President Roosevelt was prepared to yield up to a point, he stuck to the fundamental principle. Moreover, he committed the same tactical error as M. Blum, in yielding to the Rich Men's Revolt gradually and reluctantly. MM. Blum and Auriol satisfied the demand of the "200 families" to a very large degree between September 1936 and March 1937. Had they done so with one magnanimous gesture, they might have disarmed opposition. They yielded, however, step by step with the utmost reluctance, whenever circumstances forced them to do so. They made concessions to capital and enterprise at the rate of "one tablespoonful at a time". The result was that there was no reconciliation between the opposing sides, and the "200 families", encouraged by their success, held out for more and more. This is exactly what happened in the United States during the autumn of 1937. Had President Roosevelt made his concessions all at once, the result would in all probability have been a revival of

confidence and a turn in the tide. As it was, since he doled out his concessions with obvious reluctance, to a large extent these concessions fell flat. The encouragement to which they gave rise was a mere drop in the ocean of pessimism.

Above all, President Roosevelt was not prepared to yield in the matter of the Wages and Hours Bill. He was determined to force it through Congress. Had he succeeded, nothing could have prevented a disastrous slump. Fortunately, Congress had more common sense than the President. A powerful group composed of both Republicans and Democrats was formed to defeat the Bill in Congress, and the House of Representatives rejected it. Thus President Roosevelt's dilemma was solved for him by a revolt of Congress. It cost him some temporary loss of prestige. Twelve months after his sweeping victory at the Presidential Election, he was faced with the wholesale defection of his own supporters. It appeared as though his power for good or evil had declined. The initiative seemed to have been taken out of his hands by Congress.

By that time, however, the trade recession had gone so far that it could not be reversed by the rejection of the Wages and Hours Bill. In fact, the use of the term " trade recession " was beginning to become a mere euphemism to cover the reality of slump and depression. By the end of 1937 trade conditions in the United States had become more depressed than they had been at any time since 1933.

CHAPTER XXIX

SETBACK IN TRADE OUTSIDE THE UNITED STATES

(1) Signs of Recession in Great Britain

Although the United States was the chief victim of the trade recession, the effects of the latter soon became noticeable in various European countries. This was only natural. Such is the importance of the United States as an economic unit that any upward or downward trend is bound to produce a considerable effect outside her borders. In 1929 it was the Wall Street slump which gave rise to what is regarded as the biggest world-wide depression and international financial crisis in modern history. In 1933 it was President Roosevelt's reflationary measures that turned the tide not only in the United States but also all over the world. Again in 1937 the recession in the United States inevitably reacted upon trade in most other countries.

Great Britain, with her close economic and psychological ties with the United States, was the first to feel the effects of the setback. We have seen in previous chapters how the jitters spread from Wall Street to the London markets, culminating in a defeatist whispering campaign against a number of banking houses. The result of the losses caused by the Stock Exchange slump and the general pessimism regarding the prospects was a sharp decline in employment in Great Britain during the autumn. Bank advances continued to increase, it is true, but this was partly due to seasonal influences and partly to the absence of issuing activity. Other indices, such as the figures of provincial clearing, pointed to a decline in business activity.

(2) Government's Ostrich-like Attitude

In face of the undeniable evidence of the decline, the Government sought to adopt an ostrich-like attitude. It simply refused to admit that trade was not as good as it had been a few months earlier. On every possible occasion, Cabinet Ministers emphasised that trade was good, and strongly condemned anyone who expressed views to the contrary, saying

that by adopting a defeatist attitude the public would itself contribute to the depression. Doubtless this was true, but this did not mean that the opposite attitude, that of making light of the setback and doing nothing about it, was right.

The trade setback, as it became more and more obvious, caused a revival of agitation in favour of Government intervention in the form of public works. Once more the Government was called upon to undertake wholesale slum clearance and road-building. Most of those who wrote and spoke about this subject overlooked the fact that the Government was actually engaged in public works on a large scale, by pursuing its rearmament programme, and that the speeding up of rearmament would provide excellent opportunities for creating employment during a period of business recession. Nor has the Government, up to the time of writing, shown any signs of intending to take advantage of the setback to speed up its rearmament programme, which in any case was hopelessly behind schedule. Yet the decline in trade activity provided an excellent opportunity to do so.

(3) Trade *v.* National Defence

During the earlier part of the year, the progress of trade recovery handicapped rearmament to no slight degree. Owing to the large demand for limousines by armament profiteers, there were not enough skilled mechanics to manufacture aeroplanes or to serve in the Air Force. Wages and profits in actual armament works were subject to regulations and limitations, while no limit was set to them in other branches of industry. For this reason, both labour and capital regarded rearmament work as something of secondary importance, to be undertaken when there was nothing better to do.

The scarcity of several kinds of raw material essential for rearmament was also developing. Since the Government was determined not to interfere with the sacred freedom of industries, it was possible for civilian requirements, including luxury requirements, to take precedence, regarding both raw materials and skilled hands, over the vital requirements of national defence.

At the same time the upward trend threatened to cause difficulties regarding the financing of rearmament. The issue of the first instalment of the National Defence Loan was a complete failure, and it took about six months for the Public Departments to unload the bonds which they had had to take over in the absence of market demand. The upward

trend of commodities and equities threatened to increase the cost of rearmament financing.

Needless to say, none of these difficulties was impossible of solution, if the Government had only decided to tackle the problem with a firm hand in the sphere of industry and finance. In her book *The £. s. d. of National Defence*, Miss P. M. Rae made a number of suggestions as to how the problem of national defence amidst a boom could and should be tackled. The Government, however, was reluctant to resort to any advanced measures of interference with trade and finance for the sake of the efficiency of rearmament. In this respect it was supported by the predominant majority of newspapers, who denounced any departure from *laissez-faire* as rank Fascism. To stigmatise any suggestion as Fascism was sufficient to rule it out of court.

"What is the use of rearming to defend democracy against Fascism if, for the sake of the efficiency of rearmament, we submit to Fascist measures?" was the line of argument. What these champions of *laissez-faire* overlooked was that voluntary submission to control and planning in industry and finance might obviate much more drastic restriction of the freedom of the economic system and every other manifestation of life, not by a benevolent Government but by a malevolent conqueror. The logical conclusion to be inferred from the popular anti-interventionist argument is that it is better to be conquered by Hitler than to defeat him by taking a few leaves out of his book.

(4) A Missed Opportunity

The collapse of the boom through the gold scare and the subsequent recession cut the Gordian knot of the controversy. There was no longer any need to interfere with the excessive civilian requirements for the sake of securing precedence for the requirements of national defence. There was in any case a decline in the demand for goods by the civilian population, and skilled mechanics were no longer scarce. At the same time the slump in commodities released substantial stocks held by speculators, so that the scarcity of raw materials also ceased. Nor was it any longer difficult to tackle the financial problem of rearmament. By September the first £100 million of National Defence Loan had been absorbed by the market, and thanks to the liquidity-preference of the public, caused by the fall in equities, the gilt-edged market was inclined to be steady to firm. There would no longer have been any

difficulty in placing a second instalment of the National Defence Loan.

Up to the time of writing the Government has failed to grasp its opportunity for speeding up rearmament. In a public statement made in December, Sir Thomas Inskip, Minister for the Co-ordination of National Defence, desirous of reassuring the public, emphasised the fact that rearmament was proceeding according to schedule and that it was likely to reach its peak in 1939. From the point of view of checking a trade setback, however, it would have been wiser to speed up rearmament, especially as, owing to the tension in the Mediterranean and in the Far East, this was also in the interests of national defence.

Even though the Government did not take advantage of the possibilities provided by the trade recession, the falling-off of civilian demand automatically facilitated the task of rearmament. From every point of view it would have been better if this assistance to rearmament had been brought about by deliberate action at the beginning of the year rather than by an unwanted trade setback at the end of the year.

(5) The Recession in France

The trade recession did not fail to affect France, notwithstanding the fact that, owing to the specific factors operating through the depreciation of the franc and the application of the 40-hour week, the trend in France was to a large degree independent of the world trend. To some extent the recession was welcome in France, since it meant a setback in world prices, obviating a rise in the French price level, which would otherwise have taken place following upon the application of the 40-hour week and the further depreciation of the franc. In fact, the Chautemps–Bonnet Government claimed credit—as Governments are apt to do on such occasions—for the absence of a rise in prices. What was much more important, the setback in Wall Street and the general feeling of uncertainty about prospects abroad resulted in a certain amount of repatriation of French capital. But for the trade recession in the United States and the Stock Exchange slumps in Wall Street, London and Amsterdam, M. Bonnet's fiscal measures and the Government's change of policy regarding the industrial situation would not have been able to bring about even the modest respite experienced during the last quarter of the year.

There was, however, another side to the picture. In the ordinary course the revival of confidence, however moderate,

should have been accompanied by a corresponding revival of trade. After all, a certain amount of French capital had been repatriated, and it was no longer quite so difficult to obtain funds for financing enterprise. France did not, however, escape the influence of the trade recession abroad. Simultaneously with the moderate decline in her price level there was also a decline in trade activity. To some extent this was attributable to the closing of the Paris Exhibition, which could not but affect the trades dependent on tourist traffic. To a larger extent, however, the recession in France was due to the influence of adverse conditions in the world markets. French trade thus failed to benefit materially from the repatriation of capital or from the very marked depreciation and temporary undervaluation of the franc.

(6) Reactions in Other European Countries

Although Germany and Italy succeeded to a large degree in isolating themselves from the world trend by means of placing their foreign trade and transfers on an artificial basis, even those two countries did not altogether escape the indirect influence of the recession. Earlier in the year, German export trade benefited by the increased purchasing power of the raw-material-producing countries, and also by the fact that British industries were kept fully occupied by rearmament and by the increase of internal consumption. The slump in commodities resulted in a contraction of the purchasing power of raw-material-producing countries, and this in itself tended to affect adversely the export trade of both Germany and Italy. Moreover, British manufacturers, not being quite so sure of their internal markets as during the earlier part of the year, began to concentrate once more upon their overseas markets. The world-wide recession must have contributed to no slight degree to the increase of Italian exchange difficulties.

The smaller European countries also came under the influence of the world trend to a greater or less degree. The agricultural countries of Central and South-Eastern Europe were affected by the drop in produce prices at a time when they were well on the way to regaining their prosperity. Up to the time of writing, the recession in most of these countries has been very moderate. On the other hand, in Sweden, where at the beginning of 1937 many people had been inclined to imagine that they had concluded a convention with Providence for everlasting prosperity, there were distinct signs of a setback. In Holland, trade was beginning to feel the change

for the worse, since during the brief period of prosperity that followed the devaluation of the guilder there was very little opportunity to replenish the reserves, depleted during the "seven lean years" from 1929 to 1936 which followed the "seven fat years" from 1922 to 1929.

(7) Effect Outside Europe

It goes without saying that the British Dominions and other countries outside Europe were also materially affected by the fall in commodities. Canada did not share the adverse trend to anything like the extent to which it prevailed in the United States, but the reaction after several years of prosperity was decidedly noticeable. The same was true about the other Dominions, not excluding South Africa, where trade has not altogether recovered from the very severe shock administered by the gold scare. In the Far East the Sino-Japanese War overshadowed the influence of the trade recession.

Great Britain was by no means the only country where rearmament received an automatic stimulus from the trade recession. That factor assisted the aggressive countries as well as the pacific ones. Admittedly, since in Germany and Italy civil requirements were subordinated to rearmament requirements, the trade setback had not the same significance from the point of view of rearmament as in Great Britain or France. On the other hand, the slump in commodities helped Germany and Italy in their task of accumulating raw material. While in Great Britain the question of building up raw-material reserves in case of emergency was still at the stage of academic discussion, in the totalitarian States considerable quantities of raw materials had been accumulated. The fall in the price and the reappearance of supplies made it easier for them to add to their stocks, even though, as has been pointed out, the increased difficulties of the export trade operated in the opposite direction.

PART VII

GOLD RUSH AND DOLLAR SCARE

CHAPTER XXX

BACK TO GOLD

(1) Anti-climax after Gold Scare

If in June 1937 anyone had suggested that within less than three months gold hoarding might be resumed, he would have been regarded at best as an incurable optimist and at worst as a raving lunatic. Even those who firmly believed in gold throughout the gold scare were convinced that gold would remain under a cloud for years. They expected that, although the acute gold scare would subside, vague fears about the distant prospects of gold would remain and would give rise from time to time to fresh acute gold scares.

For nearly two months after the disappearance of the discount on gold, the gold market remained devoid of interest. The dishoarding fever had come to an end, largely because most people who were able and willing to dishoard had already done so. On the other hand, demand for the metal remained at a low ebb. It was confined to purchases for the current requirements of the trade, and for the covering of the short positions created during the gold scare. The bulk of the newly produced gold was taken up by the Exchange Equalisation Account, if it was in excess of the natural absorbing capacity of the market. The turnover in the market itself was very small. Throughout July and August it seldom exceeded £100,000 at the fixing on any one day. It is true that the bear covering assumed the form of forward buying after fixing. Even allowing for this, the total volume was below normal.

With the cessation of the gold scare, the agitation in favour of a cut in the price of gold also subsided. Occasional belated articles written during the gold scare were published in quarterly reviews, but those who had been loudest during the gold scare kept remarkably silent once the panic in the market had subsided.

(2) Revival of Hoarding

Towards the end of August, and even more early in September, interest in gold began to revive. Gradually and

almost imperceptibly the volume of turnover increased, not so much at the fixing, when only spot gold was dealt in, as after the fixing, when the volume of bear covering operations began to increase. This tendency largely escaped attention until it led to the reappearance of a premium on gold in September.

During the second half of August, rehoarding on a small scale became noticeable. The buyers were mostly Frenchmen, and the movement was connected with the new flight of capital from France. Part of the new refugee funds was invested in gold in preference to foreign currencies. There was also re-hoarding on the part of former holders who had liquidated in haste during the gold scare. They gradually realised that their fears had been unfounded, and after some hesitation decided to reconstitute at least part of their former deposits. This movement increased materially during September, when the franc slump was approaching its climax.

Simultaneously with the reappearance of a premium on gold, forward gold also went to a premium in relation to spot gold. This was due at first to bear covering and subsequently to a certain amount of bull operations. At the same time there was a noteworthy revival of the traffic in gold coins. Earlier in the year, the unofficial embargo on the sale of gold coins to hoarders and on dealings in gold coins at a premium had been removed, but during the gold scare the traffic assumed an entirely one-sided character. Holders of coins hastened to dishoard, and the coins were sold at their bullion value, less melting charge. Towards the end of August, however, a demand for gold coins developed for retail hoarding, in France and other continental countries. Accordingly coins went to a small but increasing premium against their bullion value. The turnover assumed considerable dimensions and owing to the fact that most of the very substantial private holdings of coins were melted down during the gold scare, it was difficult to satisfy the growing demand.

(3) Causes of Demand for Gold

The franc scare was one of the causes of the revival of the demand for gold. There were, however, other factors at work. In the first place, the growing international political tension induced many people in France, Belgium and other continental countries to seek safety in gold. The dishoarding of gold during the gold scare evidently went too far, and it was natural that the disappearance of its cause should lead to the reversal

of the movement. There was, in addition, the trade recession and the setback in commodities, and, above all, the slump in Stock Exchanges. The liquidity-preference brought about by this adverse change in the trend manifested itself in particular in the acquisition of gold as a temporary investment. As during the crisis of 1931, many people considered gold the only safe thing to hold in case of an aggravation of the setback. There were also vague rumours about the possibility of a devaluation of the dollar as a means to check the recession, though it was not until a later stage that these rumours began to play an important rôle.

(4) Soviet Gold Production Fears Allayed

Views about the fundamental gold position also underwent a distinct improvement. The bogy of Russian gold production ceased to be regarded as being as dangerous as during the gold scare. The fact that, contrary to previous practice, the Soviet authorities had not published quarterly figures during 1937 was regarded as an indication that the progress was not at all satisfactory from the point of view of the Soviet authorities. There were other indications pointing to the same conclusion. Mr. Sherebrovski, the head of the gold-mining industry in the Soviet Union, was removed from his post. Until a few months earlier he had been fêted as one of the " heroes of labour " in the Soviet Union, and special favours had been showered upon him from Moscow. He was even sent on a trip abroad, which is surely a sign of the highest degrèe of confidence. The fact that in June 1937 he was suddenly removed from his post, and transferred to another department where he occupied a subordinate position, was in itself sufficient to indicate that all was not well with the Soviet gold-mining industry. There was also much talk about sabotage and wrecking. The volume of gold exports from Soviet Russia declined considerably. Whether this was due to the fact that supplies were low, or to the fact that the Soviet Government no longer considered it urgent to unload its gold stock, it was distinctly a favourable sign.

The publication of a special gold number of the official illustrated magazine *The U.S.S.R. in Construction* gave rise to further hope that, after all, Russian gold production was not so dangerous as it had appeared a few months earlier. The most favourable point contained in the report was the statement, supported by figures, that the Soviet gold-mining industry had become to a very large extent mechanised.

Until the official announcement of this fact, it had been generally believed even in well-informed quarters that the extent to which Soviet gold-mining had been mechanised was very small, so that there were immense possibilities for increased output through mechanisation. Since, however, the mechanisation had to a large extent been accomplished, there was no need to anticipate an unduly large increase of gold production on that account. Another favourable point in the special report was what amounted to a declaration of faith, on the part of the Soviet Government, in gold as the basis of the Soviet currency. This official statement disposed of the theory that the large Russian gold exports in March and April 1937 had been the result of a deliberate policy to unload the gold reserve upon the capitalist countries and manage the Soviet currency without a gold reserve.

(5) No Spectacular Increase of Output Expected

The scant statistical material contained in the special number was also comforting from the point of view of the world prospects of gold. According to the chart reproduced in the special number, the gold output increased between 1930 and 1936 by 340 per cent, while during the same period the quantity of ore treated increased by 401 per cent. The fact that the quantity of ore treated increased to a larger degree than the net output clearly indicated that lower-grade ores were being used more than before. In a country where gold production is conducted on a commercial basis, this might simply indicate a conservative policy. In fact, as is well known, the South African gold-mining companies, ever since 1932, have been concentrating on low-grade ores, reserving their high-grades ores for times when margins of profit will not be large enough to enable them to work the low-grade ores. In the case of Soviet Russia, however, it was the declared policy of the Government to increase the output by every possible means and as fast as possible. That in spite of this they had to resort to low-grade ores may be taken as evidence that they could not find a sufficient quantity of high-grade ores. Admittedly, it is also possible that the use of lower-grade ores was the result of the increase of mechanisation. Since by far the larger part of the Soviet gold-fields consist of alluvial gold, the substitution of dredgers for human labour in their exploitation necessarily means an increase in the quantity of lower-grade ores treated. Even if this interpretation is accepted, it is a favourable point for world gold prospects, since it

indicates that mechanisation has made considerable progress, so that, as is pointed out above, no further spectacular increase of production can be expected on that account.

(6) Change in American Attitude

A much more important factor in the gold position was the change in the trend in the United States. As we saw in Chapter V the main cause of the gold scare was President Roosevelt's statement condemning the rise in commodity prices and foreshadowing measures against it. The recession that began to develop in August and September removed the necessity for any such measures. Had the termination of the gold scare been followed by a revival of the boom, possibly it would have given rise to fresh fears that the Washington Administration might resort to a cut in the price of gold, or, at least, to gold scare tactics, in order to check the upward movement. Since, however, the downward trend that developed during the gold scare continued after a brief interval, there was no need to anticipate any moves from Washington which would in any way be detrimental to the prospects of gold. What is more, under the influence of the recession, President Roosevelt, who earlier in the year, and even in 1936, had shown signs of drifting towards monetary orthodoxy, began to drift back towards monetary radicalism. He reverted to his cheap-money policy, which he had abandoned in 1936. It was this change of policy that gave rise to rumours of an impending devaluation of the dollar, rumours which played a predominant part in the subsequent accentuation of the flight from the dollar.

During the greater part of September the resumption of gold hoarding was somewhat hesitating. It came in spasms, and in the intervals interest in gold subsided. The premium remained for the most part at the nominal figure of $\frac{1}{2}d.$, disappearing from time to time. The turnover was at times considerable, but its volume was not sufficient to justify the movement being regarded as a flight to gold or, as it later came to be called, an "inverted gold scare".

(7) Authorities satisfy Hoarding Demand

The reason why the premium for a time remained nominal in spite of the increase of demand was that the Exchange Equalisation Account readily supplied the gold required for hoarding. In the absence of official selling, the supply available in the market would not have been nearly sufficient to

meet the hoarding demand, and the premium would have jumped to a very high figure. Throughout September the authorities pursued the policy of keeping down the premium, and to that end they allotted in full all the buying orders submitted at the fixing, and even after the fixing.

Hoarding demand for coins was also satisfied, though not from British official quarters. At one time, owing to the scarcity of the supply, the premium rose to more than 1*s.* per sovereign, but it declined suddenly owing to the appearance of large quantities of sovereigns in the market. These sovereigns were supplied by the Netherlands Bank in return for the delivery of bar gold. While the British authorities refused to take advantage of the premium, it was too much to expect the Dutch to refrain from snatching a profit when there was one. The Netherlands Bank's attitude in this respect was strongly resented by Mr. Montagu Norman, and on the occasion of the meeting of Central Bankers at Basle in October he reproached Dr. Trip for having encouraged the practice of gold hoarding. Dr. Trip's reply was that, since there was a demand for gold it was perfectly legitimate for a Central Bank to satisfy that demand, and that in any case it was desirable to encourage gold hoarding, so as to secure the absorption of excessive gold supplies. The Dutch example was subsequently followed by the Swiss National Bank, the National Bank of Belgium, the Bank of Portugal, and—*et tu Brute!*—even the Canadian monetary authorities.

While the Exchange Equalisation Account was readily supplying bar gold throughout September to meet hoarding demand, it refrained from satisfying demand for gold for forward delivery. In theory the embargo on speculative forward transactions in gold was still in force and the authorities were reluctant to remove it, possibly because they felt that it would aggravate the position of the franc if they encouraged this method of speculation against it. In reality, the embargo was entirely inoperative. The volume of forward dealing increased more rapidly than that of spot dealing, and the turnover in forward gold after the fixing at times reached very large figures. The counterpart had to be found in the market in the absence of official selling, and owing to the reluctance of sellers the premium had risen materially by the end of September.

(8) Increase of Gold Deposits

Most London banks were beginning to notice an increase of the amount of the gold deposits held by them on behalf of their customers, and the demand for safe accommodation, which had declined considerably a few months earlier, revived once more. Continental week-end visitors with their gold bar or bag of sovereigns reappeared in the City. The movement was not yet sweeping, but it certainly was as pronounced as it had been during the flight to gold which began with the suspension of the gold standard in 1931.

Simultaneously with the revival of the demand for gold, interest also revived in gold-mining shares. The latter were a neglected market even after the end of the gold scare, but during September a strong speculative and investing demand developed in Kaffirs.

In the course of September, the rumours of an impending devaluation of the dollar to 50 cents became increasingly persistent. This factor accounted for the accentuation of the demand for gold to no slight degree. The rumours brought about a flight from the dollar and most of the funds withdrawn from New York were invested in gold. Since, however, part of them were converted into sterling, the sterling–dollar rate underwent a marked rise and this tended to lower the London price of gold. Simultaneously with the depreciation of the dollar the premium on gold began to widen, so that the fall in the London price of gold was not proportionate to the appreciation of sterling in terms of dollars.

In less than three months after the cessation of the acute gold scare, we were in the middle of a gold boom. The lessons of this experience are worth retaining.

CHAPTER XXXI

THE INVERTED GOLD SCARE

(1) Large Increase of Turnover in London Gold Market

Throughout September the revival of gold hoarding proceeded on a comparatively moderate scale. There was nothing abnormal about the movement itself or about its extent. The premium was kept down to a nominal figure, disappearing altogether from time to time as the demand for gold slackened. The whole movement would be interpreted as the natural reaction from the exaggerated movement of dishoarding witnessed earlier in the year. From the beginning of October, however, the gold-hoarding movement assumed a distinctly abnormal character. The buying pressure on gold increased to figures comparable to those of the dishoarding movement at its highest point.

The turnover itself increased to the level touched during the gold scare. The figures published day after day as representing the amount sold at the fixing did not in any way indicate the true extent of the buying pressure, for more often than not the amount of gold that changed hands after the fixing was larger than the amount bought at the fixing. This was the result of the official attempt to conceal the full extent of the rehoarding demand. The Exchange Equalisation Account was virtually the only seller of gold, while everybody else was buying. It was the banking house of N. M. Rothschild & Sons, acting as agents for the authorities, that determined both the price and the amount available for satisfying the demand. When it was found that the total volume of demand was very large, the official agents requested the bullion brokers to hold back some of their buying orders until after the fixing. As a result, a comparatively small amount was published as representing the turnover at the fixing, and the balance of the orders was satisfied after the fixing.

(2) Official Tactics

As is well known, the amount of the turnover after the fixing is not officially announced, and there is always a certain

amount of doubt about the authenticity of the unofficial figures published in the Press. For this reason the transactions concluded after the fixing do not make the same impression upon the public as those concluded during the fixing. Let us suppose that on one particular day the total of buying orders at the fixing was £3 million. If the whole amount had been satisfied at the fixing, and it had been officially announced that £3 million of gold had been sold, this announcement would probably have accentuated the hoarding demand by giving wide publicity to the full extent of the buying. If, however, only £1 million had been transacted at the fixing, and £2 million after the fixing, then the official announcement of the figure of £1 million, with vague and often conflicting reports about further large amounts being transacted after the fixing, would not have created the same impression. For the same reason the authorities from time to time requested the bullion brokers to defer the execution of some of their orders until the following day. Evidently the *mañana* system is not confined to Spain.

Needless to say, such tactics could make but little difference in face of the sweeping movement which was increasing in intensity. Brokers were inundated with orders to buy gold. Their clients were almost as impatient to get into gold as they had been a few months earlier to get out of it. They were quite prepared to pay a premium so long as they got their gold. The figure of the premium increased simultaneously with the rise in the turnover. It was not the natural result of the relations between supply and demand, but simply the outcome of official tactics about which more will be said later.

(3) Why Hoarding Movement Became Accentuated

We saw in the last chapter the causes that led to the revival of gold hoarding. It was the accentuation of the factors enumerated there, or at any rate of some of them, that led to the accentuation of the gold-hoarding movement. By October the whole world was seized by acute fear of the coming slump and depression. The number of people who sought safety in gold was increasing. The international currency outlook also became more obscure. It looked as though the franc would continue to fall almost indefinitely. The resignation of the van Zeeland Government resulted in fears of a collapse of the belga with repercussions upon the guilder, the Swiss franc and other currencies. Above all, the talk of a possible devaluation of the dollar assumed a more definite form. The

international political tension also increased, and this naturally resulted in an increase of demand for gold as the most convenient form in which to keep wealth in war-time. All these and other factors contributed to the accentuation of the inverted gold scare.

To some extent the movement merely amounted to the substitution of one form of hoarding for another. When during the second quarter of the year hundreds of millions of pounds' worth of gold was sold by individual hoarders to the American and British authorities, the movement was generally described as being one of dishoarding. In reality, only a small fraction of the amount involved was actually dishoarded. By far the larger part of the gold hoards simply changed its form. Instead of being held in gold it was henceforth held in dollars or sterling. This movement now became reversed, and hoarded wealth was being switched back into gold. To a by no means inconsiderable degree, however, the demand for gold represented entirely new hoarding. Holders of equities and other assets considered it safer to sell out and acquire gold. Liquid cash balances were invested in gold.

(4) Attitude of Governments and Central Banks

In official quarters this revival of hoarding was received with mixed feelings. The British and United States Governments, pressed by those who would have liked them to reduce their buying price of gold, felt relieved when the gold scare gave rise to a revival of confidence in gold. In any case they were not prepared to make the suicidal decision which was pressed upon them, but they felt uncomfortable under the barrage of the unsolicited advice of gold-scaremongers. With the revival of gold hoarding, they felt that their action—or rather, inaction—was vindicated. The policy of "When in doubt—do nothing" had proved to be the right one.

In Central Banking circles, on the other hand, the movement of rehoarding was not nearly so popular as in Government circles. Some Central Bankers, it is true, felt that the willingness of the public to carry part of the surplus gold was all to the good, since to that extent the authorities were relieved of the necessity of financing sterilised gold. Others, however, held the view that since sooner or later the newly hoarded gold would also be dishoarded, the increase of privately owned gold stocks introduced a new element of uncertainty. When in June it became evident that the volume of hoarded gold had

contracted as a result of wholesale dishoarding, this fact was registered with satisfaction, on the ground that it removed one of the potential dangers to monetary stability. It was suggested at the time that since the authorities had collected from private holders most of the hoarded gold, they would never again allow private holders to accumulate again uncomfortably large gold stocks. The conception that monetary gold stocks should be concentrated in the hands of the authorities was gaining ground as a result of dishoarding during the gold scare. This provided yet another example of how easy it is to make a virtue of necessity. The moment hoarding was resumed the authorities were quite prepared to let private hoarders have the metal, which they would have been unable to obtain in large enough quantities from unofficial sources.

(5) Inconsistent Official Policy

In this respect, however, the official attitude was not altogether consistent. The authorities might have adopted one of two courses. They might have decided that rehoarding was a bad thing and should be checked as far as possible; or they might have decided that rehoarding was a blessing, and should be encouraged, or at any rate allowed to take its course unhampered. The official attitude was somewhere between the two possible courses. The authorities could easily have checked rehoarding, by completely abstaining from satisfying the demand for hoarding purposes and by continuing to absorb most of the newly mined gold. In that case, the premium would have risen to a fantastic figure, until it was high enough to induce private holders to unload at a profit. Hoarded gold would have changed hands, but would not materially have increased in volume. Alternatively, the authorities might have indicated their approval of hoarding by selling gold to an unlimited amount at the American shipping parity.

Instead of taking either of the two logical courses, the authorities resorted to the tactics described above, of trying to discourage gold hoarding without actually attempting to check it. During October they resorted to rationing the market. Only part of the hoarding demand was satisfied. The result was a rise in the premium, though not to a sufficiently high degree to induce private holders to sell out, or even to discourage private hoarding. It is difficult to explain the strange official attitude. Presumably the authorities were unable to make up their minds whether they were actually in favour of the new movement or against it, and in the absence

of any definite policy resorted to the type of compromise customary on such occasions; or possibly all that happened was that some official in charge of the Exchange Equalisation Account operations took up a certain line for tactical reasons, and his attitude subsequently became the basic principle of official policy. More often than not this is the way in which official foreign exchange and gold policy is developed. A subordinate official rightly or wrongly adopts a certain course. His line of action becomes the official tactics of the authorities concerned. Subsequently the authorities discover that the tactics in question have for some time constituted their policy, and before long it comes to be regarded as a matter of sacred tradition, any departure from which cannot be undertaken lightly.

(6) Mistaken Tactics

The attitude of the authorities in face of the hoarding movement was more or less the same as their attitude in face of the dishoarding movement earlier in the year. At that time, too, instead of buying everything or, alternatively, buying nothing, they bought with obvious reluctance, doing their best to postpone the purchase of large amounts until the next day, and allowing the discount on gold to widen. The result was that they had to take up much larger amounts than they would if they had been obviously willing buyers at par. The development of a big discount accentuated the panic and increased the volume of dishoarding. Similarly the development of a big premium during October stimulated the flight to gold and increased the volume of demand. It is reasonable to assume that during the whole period of inverted gold scare the authorities had to sell much larger amounts than they would if they had been willing sellers of unlimited quantities at par.

The official attitude during the inverted gold scare was open to criticism also on different grounds. Throughout the period, sterling was appreciating against dollars. This was the result of the dollar devaluation rumours, but then it was the duty of the authorities to prevent such factors from producing their effect. The whole idea of the Tripartite Agreement was to safeguard the currencies against such fluctuations. The appreciation of sterling by nearly 2 per cent was entirely uncalled for and should have been prevented by the Exchange Equalisation Account. Evidently the British authorities were selling too much gold and the American authorities were not

selling enough. Had the American authorities been selling on a sufficiently large scale from the very outset, the demand for dollars thus created would have offset the effects of the dollar scare. Alternatively, the Exchange Equalisation Account might have taken it upon itself to buy dollars and convert them into gold in accordance with the terms of the Tripartite Agreement. If this was not done on a sufficient scale, it was either because the Exchange Equalisation Account did not take enough trouble to check the unwanted appreciation of sterling or because it was feared in London that the operation would be viewed with disfavour in Washington. However it may be, the policy, or absence of policy, of the authorities during the inverted gold scare left much to be desired.

CHAPTER XXXII

CLIMAX OF THE GOLD RUSH

(1) Reluctance of the Authorities to Part with Gold

The upward course of gold hoarding did not by any means proceed at an even pace. In October the recovery of the franc had resulted in a temporary setback in the demand for gold on French account. There was, however, no dishoarding of gold in connection with French repatriations. Most of the French capital that had found its way back to France was withdrawn from New York. Before very long the uncertain trade and international political outlook resulted in a revival of the movement, which continued throughout October and during part of November.

Although no statistical details were available, most banks agreed that the gold deposits which they held on behalf of their customers had increased appreciably from the lowest point which they reached during the summer. Nor were private individuals the only holders who reverted to gold. The monetary authorities of various countries followed the lead of private hoarders. Gold export from Soviet Russia came to a complete standstill. This may have been due to some extent to the slackening of production, but even allowing for this factor the absence of Russian gold exports during the period of the inverted gold scare was remarkable. The Soviet authorities must have come to the conclusion that it was safer to stick to their gold than to convert it into foreign balances.

The reluctance with which the Exchange Equalisation Account was selling gold to private hoarders showed that after all the much-abused "unwanted surplus" was not so unwanted as many people had believed it to be. Notwithstanding the fact that the official gold holding had to be financed by means of Treasury bills at a cost of a shade over ½ per cent per annum, the Government was by no means anxious to reduce its gold stock. Nor was the United States Government, with its gigantic gold stock, very keen on ridding itself of the surplus. The fact of the depreciation of the dollar during the inverted gold scare showed that it was only with much reluctance that the Washington authorities parted with gold.

(2) Uncertainty about Attitude of United States

One of the reasons for the keen demand for the metal was the uncertainty whether the Washington authorities would be willing to part with gold at all. As is well known, since November 1936 the Washington Treasury had refused to sell gold for shipment abroad by private arbitrageurs. If it had been at all keen on losing gold, the first step in that direction would have been to remove this obstacle to the gold outflow. This, however, was not done. Gold could not leave the United States unless it was exported by the Washington Treasury itself or earmarked or withdrawn by one of the Governments participating in the Tripartite Agreement. For weeks the market remained in complete uncertainty as to whether the Washington authorities would be prepared to part with gold, either through their own initiative or through that of another Government. At this juncture it is worth recalling that until a few months earlier the unwillingness of the Exchange Equalisation Account to buy gold more freely and thus divert the flow of gold from New York had caused strong resentment in the United States. When this is borne in mind, the change in the American attitude is indeed remarkable.

(3) "Rats Leaving the Sinking Ship"

There was, however, one country whose change of attitude towards gold was even more striking than that of the Russian, British or American authorities. This country was Switzerland. During the gold scare, the behaviour of the Swiss authorities left much to be desired. The least that could have been expected from official quarters was that they should abstain from following the example of speculators, private hoarders and arbitrageurs, and keep their heads. The behaviour of most Central Banks and Governments was indeed unexceptionable in this respect. The Swiss monetary authorities, however, acting under the influence of the gold scare, converted some of their gold stocks into dollars. Although the amount involved was not unduly large, the fact that official quarters were unloading gold in the United States might easily have influenced American public or official opinion into putting a stop to the practice by suspending the unlimited purchases of gold. The result would have been an international disaster. It was not only very selfish of the Swiss authorities to unload their unwanted gold on the United

States. It was also short-sighted from a purely Swiss point of view. Switzerland could not possibly have remained immune from the consequences of a suspension of gold purchases by the United States.

When the tide turned, the Swiss authorities once more acted under the influence of the changed market sentiments. On this occasion they re-converted some of their dollar holdings into gold, thereby accentuating the flight from the dollar and the flight to gold. Their attitude gave rise to much criticism, not only in foreign Central Banks but also in Swiss banking circles, where it was generally considered that the Swiss monetary authorities had fallen short of the standard of competence and dignity expected of official quarters. Indeed, both during the gold scare and during the inverted gold scare their behaviour was comparable to that of rats leaving a sinking ship. It was even worse, since the instincts of the rats are usually right, while those of the Swiss authorities in leaving what they thought to be a sinking ship proved to be hopelessly wrong on both occasions. Their behaviour in disregarding the principle of *noblesse oblige* deserves censure all the more, since, as subsequent events proved, it was superfluous, even from their own selfish point of view, to act in such a way as to accentuate the gold scare first and the dollar scare later. Compared with the Swiss attitude, the behaviour of various other monetary authorities engaged in selling gold coins at a premium, thereby encouraging retail hoarding in France, may be described as almost unexceptionable.

(4) Mr. Morgenthau's Reassuring Statement

After a lull caused by the recovery of the franc, gold hoarding resumed its progress. It reached its climax on November 8, when the turnover in the London market rose to a very high figure. At the same time the premium over the American shipping parity rose to 1*s.* 10*d.* This figure was considered to be the approximate theoretical gold import point. It would have been profitable for private arbitrage to take gold from the United States authorities and ship it to London for sale in the open market. This was not done, however, because the United States authorities maintained their embargo on gold exports for private arbitrage. Complete uncertainty prevailed as to whether gold would be allowed to leave the country, even through official operations. For this reason the market was by no means certain that the premium would not be allowed to rise considerably above the theoretical import point.

At this stage, however, the United States authorities deemed it necessary to step in. Mr. Morgenthau made a statement on November 8, in which he declared that the United States was willing to allow gold to leave the country. At the same time official figures showed that the Washington authorities had already lost some gold.

The evidence of the willingness of the United States to part with gold created an entirely new situation in the gold market. Hitherto it had been widely believed that the Exchange Equalisation Account was practically the only source of gold for hoarding purposes, when it chose to part with the metal. Since, however, the Washington authorities had declared themselves willing to part with gold when the necessity arose, those desirous of hoarding no longer considered it necessary to cover their requirements in haste and at an excessive premium. They realised that they could well afford to wait. It took some little time for the main cause of the accentuation of the gold rush—namely the dollar scare—to subside, since the Washington authorities carefully abstained from issuing a categorical denial of another impending devaluation. By the end of November, however, the gold-hoarding movement had declined to within normal proportions.

(5) Gold Hoarding Continues

Although the climax had passed, the tendency continued to remain in favour of gold hoarding. Whenever the international political tension became accentuated, and whenever the flight from the franc revived, the volume of gold purchases for hoarding purposes increased.

All this time Central Banks were also acquiring substantial amounts of gold, competing with private hoarders. During the gold scare, many of these, while abstaining from accentuating the panic by selling their gold, adopted the practice of accumulating their external reserves in foreign exchange in preference to gold. In the course of the last quarter of 1937, most of these newly acquired official foreign balances were repatriated. Among others, the Argentine and Yugoslav monetary authorities withdrew large amounts of gold. The only Central Bank which continued to realise its gold stocks was the Bank of Japan. This was not done, however, as a matter of policy but as a result of sheer necessity in connection with purchases abroad, due partly to the Sino-Japanese War.

During the second quarter of 1937 gold underwent the most

severe test in modern monetary history. It withstood the test remarkably well and during the fourth quarter of the year it became completely rehabilitated. Those monetary reformers who regarded the gold scare as proof that before long the value of gold would be reduced to that of scrap iron had to admit towards the end of the year that their rejoicing had been, to say the least, premature. Obviously, mankind was still deeply attached to gold, which seems to have lost none of the " mystic " quality which, according to Mr. R. H. Brand, is the basis of the rôle it plays in the monetary system. In reality the qualities for which gold has been in favour from time immemorial are not at all mystic. They are very concrete and obvious qualities, thanks to which the metal has survived the gold scare and is now once more above suspicion.

CHAPTER XXXIII

DOLLAR DEVALUATION RUMOURS

(1) Reciprocal Relations between Gold and Dollar

The phenomenon which we are to examine in this and the next chapter, that of the dollar scare, ran concurrently with the inverted gold scare, and has been constantly referred to in the chapters dealing with that movement. It is nevertheless desirable to deal with it apart from the gold-hoarding movement, since in many respects it was independent of that phenomenon. It had many aspects which could not usefully have been dealt with in discussing the gold rush, without unduly complicating the issue.

Undoubtedly, to a very large degree the gold rehoarding fever played an important part in the dollar scare, as both its cause and its effect. To a certain extent the revival of gold hoarding began as a result of vague rumours of a dollar devaluation. At the same time the weak tendency of the dollar, which stimulated the rumours of its pending devaluation, was the direct consequence of gold hoarding. It was one of the curious anomalies of the year that both gold scare and gold rush led to a weakening of dollars in relation to sterling.

(2) Why Dollars were Weak during Gold Scare and Gold Rush

The anomaly is, however, more apparent than real. During the gold scare, dollars depreciated, notwithstanding rumours of an upward revaluation, because the United States Treasury bought more gold than the equivalent of the amount of "hot money" switched over from gold into dollars. The fault was with the Exchange Equalisation Account for failing to buy enough gold to relieve the United States Treasury of the unwanted influx. As a result, the United States over-imported gold, and this produced its natural effect upon the dollar exchange.

During the inverted gold scare, dollars were weak because the United States authorities did not sell enough gold to offset the effect of the withdrawals of foreign balances from New

York. The fault was again largely with the Exchange Equalisation Account, since it sold too much gold without covering itself by buying dollars and earmarking gold with the United States authorities. On both occasions the appreciation of the dollar was due to lack of adequate technical co-operation between London and Washington, and to the omission of the Exchange Equalisation Account to take the necessary steps to prevent an unwanted appreciation of sterling.

From September onwards the dollar came under selling pressure as a result of the switching-over of "hot money" from dollars into gold. Since the United States did not freely supply the gold required for hoarding purposes, the movement was bound to weaken the dollar exchange. There were, however, other factors at work, tending to influence the dollar in the same direction.

(3) Adverse Factors Affecting the Dollar

There was in the first instance the cheap-money policy adopted by the United States authorities from August onwards. Even though interest rates have ceased to play a predominant part in influencing exchange rates, the reduction of the New York bank rate to the low record figure of 1 per cent, together with the anticipation of other reflationary measures, was likely to have some psychological effect upon the dollar. The assumption that President Roosevelt was about to embark upon a policy of monetary expansion, reversing his more orthodox policy adopted a year before, was a modest but unmistakable bear point for the dollar.

There was also evidence of an adverse change in the trade balance of the United States. The advent of a trade deficit, moderate as its figure was, gave rise to a belief that the tide had turned and that in future the visible trade balance would produce an adverse influence on the dollar. At the same time invisible items did not change in favour of the United States. For the first time since the slump, wealthy American tourists began to appear in large numbers in Europe and began to spend on the scale customary during the Wall Street boom. Foreign immigrants' remittances also increased as a result of better employment and business conditions. On the other hand, the increase in yield on foreign investments was not nearly on the same scale as in Great Britain.

(4) Devaluation Talk follows Revaluation Talk

These factors disappeared, however, into insignificance, compared with the all-important factor of devaluation rumours. To the future student of financial history it may seem the height of absurdity that only a few months after the rumours of an upward revaluation of the dollar, rumours should appear of an impending move in the opposite direction. After all, the gold position which was the basis of the dollar revaluation rumours from April onward was substantially the same in September. It was because the volume of gold in the world in general and in the United States in particular was considered excessive that the agitation in favour of a cut in the price of gold in terms of dollars arose. In the meantime the gold stock did not diminish by any means, nor did gold requirements increase materially. Nevertheless, notwithstanding the unaltered gold position, many people believed that the United States authorities would change the dollar price of gold, not in a downward direction but in an upward direction. By October the belief that the dollar price of gold would be raised became almost as widespread as the opposite belief had been six months earlier.

This experience shows how easily market opinion can be influenced by a surface development, even in the absence of a change in the fundamental situation. Those who fell easy victims to these quick changes in market sentiments towards gold and dollars may, however, argue as an excuse for their credulity, that after all the official American policy had in past years been subject to many sudden changes. Time and again President Roosevelt managed to do the unexpected. Since in the early spring the boom proceeded too fast for his liking, it was tempting to jump to the conclusion that he would stop the unwanted movement by deflating through an upward revaluation of the dollar. In the autumn, when symptoms of trade recession began to cause concern in Washington, it was equally tempting to jump to the conclusion that President Roosevelt would resort to a second devaluation of the dollar. Many of those who thought during the spring and early summer that President Roosevelt might resort to a cut in the price of gold were convinced that such a step would be utterly unreasonable; but then they had a very low opinion of his judgment and were inclined to believe that he would take a suicidal course in defiance of common sense. Many of those who during the autumn of 1937 were inclined to believe that

President Roosevelt would decide upon a second devaluation of the dollar in the immediate future were by no means convinced of the wisdom of such a step. Nevertheless, since they did not think that President Roosevelt's policy was guided by wisdom, they were inclined to believe that he would take such a step, however unwise it might be.

(5) No Official Denial of Devaluation Rumours

Nor did the Washington authorities altogether escape blame for the growth of the devaluation rumours. Throughout the period of the dollar scare there was not one single categorical denial issued by the Washington authorities. While during the gold scare the President, the Secretary of the Treasury, and other spokesmen of the Administration issued a number of statements disclaiming the intention of cutting the price of gold, during the dollar scare no statement of any sort was issued disclaiming the intention of raising the dollar price of gold. Rumourmongers were allowed a free hand, and their activities were not hampered by official denials.

It is not altogether unnatural that in the absence of official denials the theory developed in many quarters that the Washington Administration was deliberately engineering the dollar scare for the purpose of checking the trade recession. Similar views were held fairly widely in connection with the gold scare which was attributed to President Roosevelt's desire to check the boom. Fantastic as the theory may appear, it cannot be dismissed, especially as it is understood in well-informed quarters that some of the leading American Treasury officials, at any rate, were very much in favour of the idea of engineering scares in order to manage the trade cycle, instead of resorting to bank-rate changes and adjustments in the volume of credit. It seems unlikely that the gold scare was deliberately started for that purpose, but once it was in full swing, these Treasury officials may have regarded it as a blessing in disguise. It is understood that in May and June, when everybody thought that the gold scare had come to stay, the idea of regulating it in accordance with the requirements of monetary policy was under consideration in Washington. At that time it was generally believed that, as soon as the gold scare had subsided, trade would resume its upward trend and would develop into a boom unless it was checked once more by the skilful administration of another dose of gold scare. As it was, trade never recovered properly from the

effects of the first dose, and continued to decline even after the gold scare had departed.

(6) WAS DOLLAR SCARE ENGINEERED BY THE AUTHORITIES?

It is just conceivable that the Washington Treasury carried these supposed scare tactics a step further by seeking to meet the new situation by engineering an inverted gold scare. There is no evidence in support of this theory, apart from the absence of denials of the devaluation rumours. If the dollar scare was from the very outset deliberately engineered as a matter of official policy, it would, however, have been in keeping with the tactics pursued by President Roosevelt on many occasions during his régime. During the period between 1933 and 1935 he repeatedly tried to bring about a revival of trade by the threat of inflation, but in practice the bark of the Administration was often worse than its bite. His policy of raising the price of gold and silver in the hope of bringing about a rise in commodity prices and an increase in the volume of trade was also largely based upon the anticipation of the psychological effect of his gestures. It is therefore conceivable that it suited the book of the Washington Administration to spread dollar devaluation rumours, in the hope that the mere anticipation of devaluation would produce the desired effect on trade. It may have spread devaluation rumours in order to avoid having to devalue.

It is much more probable, however, that the devaluation rumours originated independently of official quarters, but that the latter regarded them as a blessing in disguise. Since so many people chose to believe that the dollar would be devalued, the American authorities let them believe it, hoping that the anticipation of a devaluation might turn the tide of trade and prices.

(7) WAS DEVALUATION CONSIDERED IN WASHINGTON?

According to yet another theory, the idea of a second devaluation was considered quite seriously in Washington in September and October. This would explain the Treasury's silence on the subject of devaluation. Even though the Administration did not decide upon that course, it wanted to leave the door open in case it had to decide to take such desperate measures at a more advanced stage of the depression.

Needless to say, the devaluation of the dollar in the autumn of 1937 would have been the height of absurdity. It would have been followed almost instantaneously by an all-round

devaluation of the leading currencies, so that American trade could not have gained any advantage over other countries. Nor is it by any means certain that all-round devaluation would have been followed by an early rise in world prices or in American prices. It is even doubtful whether the change would immediately have checked the downward trend of prices. The experience of 1933–34 went a long way towards discrediting the theory of Professors Warren, Pearson and Irving Fisher, according to which a change in the dollar value of gold would immediately be followed by a corresponding change in the American price level. It might take a number of years before a devaluation or revaluation of gold produced anything like its full effect on prices.

Devaluation in the United States and in most other countries would not have led to any actual expansion of credit. As far as the United States was concerned there was ample scope for credit expansion, even on the basis of the existing value of the dollar, and a second devaluation would merely have increased the amount of surplus credit, sterilised or unused. It would not have caused an additional demand for credit, for the simple reason that the psychological factor was against such an increase of demand. On the contrary, the shock administered by devaluation at that stage might conceivably have further unsettled the minds of the public, and might have accentuated the contraction of trade.

(8) Long-Range Aspects of Dollar Devaluation

The absurdity of a devaluation of the dollar in the autumn of 1937 becomes even more evident if we consider the long-range aspects of the problem. Those who during the spring of the same year advocated a cut in the price of gold were very short-sighted indeed, for they only thought of solving the immediate problem. They paid no regard to the fact that in the long run a cut in the price of gold might restore those very conditions of gold scarcity which had led to the all-round devaluation of currencies. Those who in the autumn of 1937 advocated a devaluation of the dollar were equally short-sighted. I am convinced that sooner or later there will be an all-round devaluation of the leading currencies, but only if the present gold surplus has to a large degree been absorbed by growing requirements. To raise the nominal amount of the gold stock by a further drastic devaluation, and to raise the current production by increasing the price of gold, would have brought about a spectacular increase in the gold surplus.

Before many months the agitation in favour of disposing o this surplus through a cut in the price of gold would have bee resumed, and the world would have witnessed another gol scare. While it was a matter of elementary wisdom not t listen to those who during the second quarter of 1937 agitate in favour of a cut in the price of gold, it was equally wise t abstain from yielding to the temptation of making a chang in the opposite direction during the last quarter of that year Although during the second half of 1937 President Roosevel reverted to a certain degree of monetary radicalism, afte having drifted towards orthodoxy during the previous tw years, he would not lightly have made up his mind to resor to such an extreme radical measure as a second devaluatio of the dollar. The idea could not be ruled out altogether, bu it stood to reason that before taking such an extreme measur he would have tried many other devices.

Nevertheless, as trade went from bad to worse, the belie that the Administration would be driven to extreme measure was gaining ground. It was hoped or feared—as the cas happened to be—that, confronted by the evidence of a really grave trade slump, President Roosevelt might altogether dis card his monetary orthodoxy of relatively recent origin, an decide to embark upon reflation at all costs. Thus it was tha devaluation rumours were spreading in proportion to th decline of trade and prices.

CHAPTER XXXIV

THE FLIGHT FROM THE DOLLAR

(1) Forecasts of a 50-cent Dollar

In the course of October the dollar scare, which during September had been somewhat hesitant, developed into a thorough flight of capital from the United States. It was mainly foreign capital that was withdrawn, but to some extent American funds also left the country, to seek safety in gold. The movement was by no means sweeping, but the mere fact that the dollar was no longer considered absolutely safe was significant. Rumours about its impending devaluation became stronger and stronger in the absence of any official denials. The rapid deterioration of trade and the weakness of Wall Street, which was likely to induce the Administration to resort to drastic measures on unorthodox lines, also accounted for the growing anticipation of a devaluation.

The popular forecast was that the value of the dollar would be reduced to its lower legal limit of 50 cents. Many quarters believed, however, that President Roosevelt would seek powers from Congress to devalue even further. There can be little doubt that Congress would have been only too willing to grant such powers.

One of the reasons why devaluation rumours found many believers was that President Roosevelt had played most of his other cards without the desired result to trade and Wall Street. His reversion to cheap money was of no avail, even when he went so far as to de-sterilise $300 million of gold from the Inactive Gold Fund. His concession to Wall Street in the form of liberal reduction of margin requirements also failed to check the downward trend. Such conciliatory gestures as he consented to make to Big Business proved to be inadequate, and since he was obviously reluctant to scrap his New Deal legislation, it was widely assumed that the only alternative stimulus to business would be a second devaluation of the dollar.

(2) Withdrawal of Foreign Funds

It is indeed remarkable that the dollar, which for years had been looked upon as the symbol of security, should come under

a cloud. As a matter of fact, the number of those who really believed that a devaluation was probable was not very large. On the other hand, the number of those who considered that devaluation was possible was large and increasing. An element of uncertainty about the future of the dollar came into being. If in spite of this the flight from the dollar did not increase to sweeping dimensions, it was partly because of the assumption that a devaluation of the dollar would be followed immediately by an all-round devaluation, and partly because most European currencies were themselves under a cloud owing to the international political tension.

The funds which were the first to leave are those acquired in anticipation of a rise in the value of the dollar. Until September 1937 everybody took it for granted that, if the dollar moved from the parity at which it had been stabilised on January 30, 1934, it could only move in an upward direction. For this reason, many people held dollars in anticipation of such a change. The moment the public began to consider it possible that after all the dollar could move in either direction, and that for the moment at any rate a downward movement was more probable than an upward movement, these speculative holdings were liquidated. Pessimism regarding the prospects of the dollar resulted in a contraction in the premium on forward dollars, and as a result, it was no longer profitable to maintain British arbitrage funds in New York. These funds were accordingly withdrawn.

Refugee funds also began to be restive. Their owners were of an essentially nervous disposition, and for many of them the barest possibility of a devaluation was a sufficient inducement to seek safety in gold or in some of the first-class European currencies. Finally, foreign capital invested in Wall Street was withdrawn on a fairly substantial scale. This was the result of the very disappointing trend prevailing in Wall Street from August onwards. It was not only speculators who decided to cut their losses, but also genuine investors who had grown thoroughly tired of the unreasonable downward trend prevailing in Wall Street.

(3) "Hot Money" Flow Reversed

"Hot money" was actually leaving the United States. This was in accordance with the declared wishes of the Administration. Ever since November 1936, when President Roosevelt had declared himself against the influx of "hot money", Administration spokesmen had lost no opportunity of empha-

sising their determination to check the influx, and to divert from New York some of the existing foreign funds. Various measures, such as discriminatory taxation and the disclosure of information to foreign Governments about the dollar holdings of their nationals, were under consideration. From time to time it looked as though President Roosevelt meant to put his threat into effect and do something about "hot money", but nothing actually happened. Occasionally there were minor scares among holders of "hot money", leading to transfers to London or some other continental centre, or even to moderate repatriations. When it was found, however, that the threats were not followed by action, the influx of "hot money" was resumed.

Now, for the first time, there was a definite outward trend of foreign funds, thanks to the uncertainty about the future of the dollar. It was only natural that this should give rise to a theory that the feeling of uncertainty had been deliberately fostered by the American authorities in order to reverse the trend of "hot money". There is no reason to believe that this theory had any foundation. For one thing, by the autumn of 1937 the Washington Administration was no longer so keen on driving out "hot money" as it had been a few months earlier. The unwanted influx of gold had come to an end and the Wall Street boom, which had been largely stimulated by foreign buying, was completely reversed. Given the general downward trend, the outflow of foreign funds on a really large scale would have been anything but desirable from the point of view of the Administration. It would have accentuated the Wall Street slump, and the evidence of a heavy outflow of gold would have produced unfavourable psychological effects. There was, it is true, no material reason why anyone should have been worried about the loss of gold, even if it had run into milliards of dollars. The effect of the outflow on the credit structure would have been neutralised through the decline of the Inactive Gold Fund, and, once this account had been exhausted, through the reduction of reserve requirements raised in 1936. Nevertheless, in all probability a really heavy outflow of gold would have accentuated the trade depression through its moral effect.

(4) United States reluctant to lose Gold

For this reason, it seems utterly improbable that the Washington Administration encouraged the gold scare in order to get rid of unwanted "hot money". On the contrary, there

is reason to suppose that the official American quarters were at this stage reluctant to lose much gold. This, at any rate, is indicated by the half-heartedness with which they intervened in support of the dollar, which was depreciating against sterling and other European currencies. A country which is not on the gold standard can lose foreign funds only if it voluntarily parts with gold. If it does not, there can be no real withdrawals of foreign balances, and all that happens is that the foreign owners of these balances sell their dollars to other foreign residents. Thus the extent to which the dollar scare led to actual withdrawals of capital from the United States was determined by the extent to which the United States authorities were prepared to part with gold. Had they been really anxious to divert part of the "hot money" and the surplus gold in the United States, the weak tendency of the dollar would have provided an excellent opportunity. All they would have had to do was to sell sterling freely and earmark gold in favour of the Exchange Equalisation Account. This was not done, however, on a sufficient scale. Judging by the depreciation of the dollar, the United States Treasury was parting with gold very reluctantly.

The result of the weak tendency of the dollar was, of course, a further accentuation of the selling pressure on it. Even those who considered it unlikely that the dollar would be devalued believed that quite possibly the weak tendency would be allowed to continue for some time. Thus while the dollar would remain unchanged in terms of gold, it would continue to depreciate in terms of sterling. The sterling–dollar rate, having risen from 4.94 to 5.02, was being talked up to 5.10, 5.20 and even higher. Nobody knew whether the Tripartite Agreement had fixed any definite limit for the sterling–dollar rate, and in any case, judging by the experience of the franc, it was obvious that such limits as may have been fixed were subject to revision.

(5) No Withdrawals through Private Arbitrage

During the gold scare, private arbitrage went a long way towards correcting the situation in spite of technical and psychological obstacles to free arbitrage. During the dollar scare, private arbitrage was, however, entirely absent. For one thing, except for one or two days, when the premium on gold was allowed to rise to 1s. 10*d*., which was regarded as the theoretical gold import point between New York and the London market, arbitrage shipments would not have been

profitable. In any case, the United States authorities had discontinued in November 1936 the sale of gold for private arbitrage. The premium was entirely determined by the Exchange Equalisation Account, and its maintenance below the gold import point appeared to pursue a deliberate object. Had the London gold market been left to its own devices, the premium would have risen to well above gold import point. This would, however, have been useless, since even abnormally high premiums would not have attracted gold from the United States. The evidence of such a premium would have created the impression that in practice, if not in law, the dollar had ceased to be linked to gold. It was therefore wise not to allow the premium to run away, even though it would have been wiser to keep its figure lower.

The American attitude towards the withdrawal of gold through private arbitrage cannot be easily explained. The measure was taken just at a time when the Washington authorities were becoming concerned about the unwanted influx of gold. Why they should have chosen that moment to make a gesture indicating that they were anything but anxious to lose gold is past understanding. It is more easily understandable that in the autumn of 1937 they were reluctant to facilitate the outflow of gold. Had the embargo on gold exports through private arbitrage been removed, and had the premium at the same time been allowed to find its level, the result would have been a steady flow of gold from New York to Europe, and this would have checked the depreciation of the dollar. The Washington authorities were, however, apparently anxious to avoid such an outflow of gold. Possibly they were desirous of bringing about a moderate depreciation of the dollar, and were reluctant for that reason to support the exchange either by allowing private arbitrage to export gold or by exporting gold on official account to a sufficiently large extent.

Throughout October and during the early part of November there was no indication of any American selling of gold. It was believed that the whole burden of the re-hoarding movement was borne by the Exchange Equalisation Account. The absence of any evidence of American selling was a strong bear point for the dollar, and was responsible for the accentuation of the movement until it reached its climax, on November 8. There was even a certain amount of speculative selling of dollars, and many Americans sold in order to reconstitute their London gold deposits, liquidated earlier in the year.

(6) France and Other Countries benefit by Dollar Scare

It is an ill wind that blows no good, and there can be no doubt that a number of countries benefited by the dollar scare to no slight extent. France was probably the chief beneficiary of the movement. The recovery of the franc, experienced in October, and its stability during November and December, would have been impossible but for the dollar scare. For one thing, it diverted attention from the franc, thus providing the Government with a badly needed breathing-space. It resulted in a certain amount of repatriation of French funds, especially on the part of French Wall Street operators. Another country which benefited from the dollar scare was Belgium. As we shall see in Chapter XXXV, the dollar scare coincided with the Belgian political crisis which threatened to undermine the stability of the belga. It seems probable that but for the dollar scare the financial effect of the prolonged Cabinet crisis in Belgium would have been much more pronounced.

Portugal also benefited by the dollar scare to a smaller degree. In November, her Government decided to remove all exchange restrictions and restore complete freedom of international transfers. This change was not followed by any noteworthy outflow of Portuguese capital, mainly because, owing to the dollar scare, it was not considered safe to transfer funds to the United States. It was presumably for the same reason that the Brazilian Government decided to experiment with the removal of exchange restrictions. In this case, however, the result was not so satisfactory and the restrictions were subsequently restored and reinforced.

(7) Mr. Morgenthau and Gold Exports

By the beginning of November the dollar scare was threatening to assume a sweeping character. The Washington Administration realised that it could no longer view the movement with indifference, and that it would have to intervene by word and deed. Accordingly, the United States authorities began to sell gold on a noticeable scale. At the same time Mr. Morgenthau issued a statement reaffirming the willingness of the Washington Administration to undertake the export of gold in support of the dollar. The effect of this announcement and of the evidence of gold shipments was instantaneous. There was a sharp reaction in dollars and in gold. Dollars recovered, while the premium on gold contracted.

Nevertheless, Mr. Morgenthau's statement did not succeed in removing altogether the fear of a devaluation. He remained completely silent on that subject. Nor did President Roosevelt categorically state that the dollar would not be devalued or that it would not be devalued in the immediate future. The question of the devaluation rumours was brought up in the course of a Press conference, and the President merely remarked that there was apparently as much speculation in rumours as there was in currencies, leaving it to the journalists and their readers to make what they chose of his cryptic remark. It is understandable that, possessing the legal right to devalue, the Administration was not anxious to commit itself to a statement amounting to the relinquishing of that right. At the same time, it might have been possible to word the denial in a way which, while ruling out the idea of the devaluation of the dollar in the near future, left the door open for the more distant future. Instead, the Administration spokesmen preferred to say nothing.

(8) Market not altogether Reassured

It is not surprising, therefore, that the market was not altogether reassured, and that, after the first reaction caused by Mr. Morgenthau's statement, the withdrawal of funds from New York and the re-hoarding of gold in London continued. Admittedly the extent of the movement diminished materially. From an acute attack it developed into a chronic tendency which continued for the rest of the year, and also in the New Year. Week after week the United States statistics registered an excess of gold exports over gold imports, in spite of the shipment of Japanese gold to San Francisco, and in spite of the material improvement of the United States trade balance during the last months of the year.

To some extent the outflow of gold was connected with the American silver purchases, which assumed considerable dimensions during November and December, as a result of heavy shipments from China. The increase of silver imports tended to produce the same effect on the dollar as a corresponding increase of goods imports. From this point of view alone the American silver-buying policy is likely to produce a highly beneficial effect, since it makes for a better distribution of gold, notwithstanding the reluctance of the United States to increase deliberately the imports of goods or to resume lending abroad. During the last two months of the year, the outflow of gold from the United States was not on such a scale

as to cause uneasiness among the American public, but it was nevertheless sufficiently persistent to make a difference to the international gold situation. In particular, gold shipments from the United States to France contributed to no slight extent towards the improvement of the position and prospects of the franc.

(9) Moderate Pressure Continued

The fact that the dollar exchange did not recover to its pre-scare level, but remained in the vicinity of 5.00 to the pound, indicated that even after Mr. Morgenthau's statement the trend of foreign funds did not become reversed. Although most people were now inclined to ridicule the idea of an immediate devaluation, there remained, nevertheless, a feeling that the Washington Administration might resort to that measure in the more distant future. It was felt that if the fall in commodity prices continued much longer, the position of the debtor classes, and of the largest debtor of all, the Federal Government, would become increasingly difficult, and the Administration might even resort to devaluation as a means of raising the price level.

The dollar remained under moderate pressure also on account of French and Belgian repatriations. Conditions in France showed a distinct improvement during the greater part of the last ten weeks of the year, and distrust in the dollar was not the only reason why some of the French balances in New York were repatriated. In Belgium the solution of the Cabinet crisis resulted in the repatriation of the Belgian capital which had taken flight abroad after M. van Zeeland's resignation. The increasingly grave situation in the Far East also tended to cause a selling pressure on the dollar. It was feared that the United States might eventually become involved in the Far Eastern conflict.

Continued gold hoarding also tended to maintain the selling pressure on the dollar. Even though the acute wave of hoarding had come to an end, there remained a fair demand for gold for ordinary purposes. Foreign holders of dollars continued to switch into gold, not so much because of any distrust in the dollar as because of their desire to reconstitute their dollar deposits and spread their risk. The Exchange Equalisation Account continued to supply the metal, and the result was a buying pressure on sterling, to counteract which it was necessary to buy gold from the United States.

(10) End of Dollar Scare

Towards the end of the year, fear of a devaluation of the dollar in the near future gradually subsided, notwithstanding the fact that no denials of the intention to devalue were issued. President Roosevelt's actions appeared to speak more eloquently than any statement could have done. In itself the Treasury's willingness to part with gold could not be regarded as evidence that no devaluation was intended. After all, in 1936 France, Holland and Switzerland parted with gold freely until the actual moment of the devaluation of their currencies. The same was the case of the United States in 1933. What reassured the public even more than the evidence of gold exports was the evidence that President Roosevelt was in a way inclined to continue to drift towards orthodoxy notwithstanding the development of a trade depression. Some of his statements were particularly calculated to allay fears about the prospects of the dollar. The frequent references of Administration spokesmen to the desire to balance the budget could not but produce a reassuring effect, even if it was by no means certain whether President Roosevelt and Mr. Morgenthau were not merely paying lip-service to budgetary orthodoxy. What was more convincing was President Roosevelt's statement regarding his gigantic housing scheme. A year or two before, that scheme would have been financed entirely by Government money. In November 1937, however, President Roosevelt indicated that he expected private capital and enterprise to finance his building scheme, and that the Government's contribution to the financing would be on a very small scale. This evidence of President Roosevelt's orthodoxy was highly reassuring from the point of view of the prospects of the dollar. After all, if he was reluctant to embark upon financing a gigantic housing scheme in order to revive trade, it stood to reason that he would also be reluctant to devalue the dollar.

By December, the dollar scare, as such, had come to a halt. It was revived, however, in February 1938, when the world experienced another spell of flight from dollars to gold. This development will be discussed in Chapter XXXIX.

PART VIII
MINOR SCARES

CHAPTER XXXV

THE TRAGEDY OF M. VAN ZEELAND

(1) A Victim of Ingratitude

During 1937 the main battles in the financial sphere were fought around the franc, around gold and around the trade position in the United States. There was, however, no lack of secondary engagements. The belga crisis that developed in October was one of them. Like the other minor battles, it deserves attention, since very often developments in a currency of secondary importance lead to decisive events in world finance. It was the devaluation of the belga in 1935 which marked the beginning of the death struggle of the Gold Bloc.

For two and a half years Belgium had had good reason to consider herself a lucky country, having as Prime Minister a statesman of exceptional ability. Anyone who had any dealings with M. van Zeeland came away with the impression that he was a statesman who knew what he wanted for the good of his country, and knew how to achieve it. There can be no doubt that the Belgian nation owes him a debt of gratitude, comparable only to that owed by the United States to President Roosevelt. Both M. van Zeeland and President Roosevelt assumed office when their nations were on the verge of collapse and chaos; they rescued their countries from the throes of crisis and guided them towards prosperity. It is a sad reflection upon human nature that neither President Roosevelt nor M. van Zeeland received any thanks from those who had most reason to be grateful, namely, those who stood to lose most through the danger averted by these two statesmen. We have seen in earlier chapters how the Rich Men's Revolt which developed in the United States during the autumn of 1937 jeopardised President Roosevelt's achievements. We shall see in this chapter how the ingratitude of Belgian High Finance, having done its utmost to increase the difficulties of M. van Zeeland's task, ended by removing him from the leadership for which he was so eminently qualified.

(2) How M. van Zeeland Saved Belgium

In March 1935 M. van Zeeland assumed office amidst the gravest possible difficulties. He gave up banking and entered politics at a moment when the professional political leaders had not the courage to face the situation. The previous Government, under M. Theunis, having obtained full powers from Parliament to take emergency measures, shirked its duty for fear that the unpopular measures which they would have to take might amount to political suicide. M. van Zeeland, having no political ambitions, did not mind facing unpopularity through assuming responsibility for what he considered to be the right course. Immediately after his advent he devalued the belga, thereby cutting the Gordian knot of the Belgian crisis. He would have preferred to join the Sterling Bloc, but was unable to obtain adequate support for this solution, and therefore did the next best thing by fixing the gold value of the belga at a lower level.

The effect of this measure was spectacular. The flow of funds, which during the last fortnight of March had threatened to deplete the National Bank's gold reserve and the liquid resources of the commercial banks, became reversed immediately. It was said that on the last day of March the leading banks in Belgium had hardly any cash left in their tills. Within a few weeks they were inundated with deposits by Belgians repatriating their capital from abroad. Within a few months, Brussels was actually suffering from an *embarras de richesse*, as a result of the heavy influx of foreign capital seeking refuge in the centre which had formerly been regarded as the weakest link in the chain of the Gold Bloc. The industrial situation changed overnight. Belgian steel and other essential products were once more in a position to compete in the world market. Unemployment declined rapidly. After years of severe deflation, wages, profits, dividends, agricultural earnings, etc., began to increase. Everybody was becoming more prosperous. Everybody was happy—or at any rate, nearly everybody. It was inevitable that this success should be regarded with disfavour by a minority, numerically insignificant but influential and dangerous.

(3) Bankers' Hostile Attitude

From the very outset M. van Zeeland was able to rely upon the support of the three leading political parties in the country —the Socialists, the Liberals and the Catholics. Notwith-

standing the sharp conflict of interest between these parties, the Prime Minister succeeded in steering a middle course that satisfied all of them. He managed to conciliate with supreme skill the inevitable friction that was bound to arise between them from time to time. He even managed to pacify the Flemish nationalists, whose growing influence was one of the chief potential sources of danger. From the very outset, however, he had to face the uncompromising opposition of High Finance.

The explanation of the hostile attitude of bankers and big business men lay mainly in the New Deal legislation introduced by M. van Zeeland. A pupil and admirer of President Roosevelt, he was regarded by his former fellow-bankers as a renegade. And yet no section of the community had more reason to be grateful to him than the bankers. It was he who saved them from the grave consequences of the deflationary monetary policy which had been pursued by his predecessors, and from the consequences of the imprudence of which several of the banks had been guilty. But for M. van Zeeland, Belgium would in 1935 have witnessed the gravest banking crisis in her history.

Some individual bankers owed M. van Zeeland a debt of gratitude also for the considerable profits which they earned through the devaluation of the belga. In the course of the inquiry that was held to ascertain the responsibility for the attack on the belga, the name of one particular Belgian banker figured with particular prominence. It became evident that, while his bank's cash resources were being depleted, he himself was among those who transferred their assets abroad, and even indulged in bear speculation against the belga. The result of this inquiry was that the banker in question had to resign his position and take up the management of a bank of secondary importance. Even though M. van Zeeland had nothing to do with the inquiry, which was undertaken at the instigation of the Socialists, this banker never forgave him for this degradation. He was determined to get even, and to that end he played a prominent part in financing the Rexist movement, which under the leadership of M. Degrelle constituted virtually the only political opposition to M. van Zeeland's Government.

(4) Intrigue and Attacks

Only a few months after the devaluation of the belga, the success of M. van Zeeland's reconstruction scheme was

jeopardised by a deliberate bear campaign against Government securities, engineered in high financial quarters. M. van Zeeland, however, succeeded in defeating this attack and his enemies were forced to the conclusion that they could do very little in the financial sphere, where M. van Zeeland's position was unassailable. They had to concentrate upon political attacks, which went on incessantly throughout his term of office. The Rexists constituted an insignificant fraction of the population, and the Belgian Government could well have afforded to ignore them, just as the National Government has ignored Sir Oswald Mosley's turbulent Fascists. M. van Zeeland was, however, too chivalrous to treat an opponent with contempt merely because the number of his followers was small. He paid M. Degrelle the entirely undeserved compliment of taking him seriously. In response to the latter's challenge, he promptly declared himself prepared to fight a by-election for his constituency in Brussels. The verdict of the electorate was, of course, overwhelmingly in his favour, but this and other incidents went a long way towards wearing down the overworked statesman.

In order to counteract the efforts of M. Degrelle to obtain the support of the Flemish nationalists, M. van Zeeland sought to conciliate that party by granting an amnesty to those guilty of political offences during the German occupation. The result was violent opposition and street riots in various parts of Belgium on the part of patriots indignant at the amnesty. Their indignation was skilfully fostered by quarters desirous of fishing in troubled waters. The Government had to resort to the use of armed force against its own supporters in order to quell the riots and, being of a highly sensitive nature, M. van Zeeland was more grieved by this than by anything else.

(5) The Affair of the National Bank

It was M. van Zeeland's excessively sensitive nature that was the cause of his tragedy. His opponents were not slow to discover that this was his Achilles' heel, and set out to find a means of wounding him there. The opportunity was provided by the discovery of certain irregularities in the affairs of the National Bank of Belgium, of which M. van Zeeland had been a director before he became Prime Minister.

The attacks directed against the National Bank of Belgium and, through it, against M. van Zeeland, may be summarised under two headings. There were some alleged irregularities

about the payment of certain bonuses to the directors—M. van Zeeland among them—and about the granting of credits to the banking firm of Goldzieher & Penso, which was controlled from behind the scenes by the notorious Barmat. As far as the payment of bonuses was concerned, it was a well-established practice long before M. van Zeeland joined the bank, and there was no reason why he should have refused to benefit by it. He was almost entirely dependent upon his salary, and the comparatively moderate bonus which he obtained was a meagre reward for the immense services which he had rendered to his country. As for the Barmat affair, the National Bank admittedly suffered some loss, but the amount involved was very small compared with its total outstanding commitments. The error was made in good faith, and the bank which has always succeeded in avoiding such errors should cast the first stone. The bank was also attacked for its reluctance to take legal proceedings against the firm in question, but then, it is in accordance with the general practice of banks to avoid as far as possible publicity concerning their mistakes. Innumerable examples could be quoted to show that leading banks in every country have preferred to suffer losses through defalcations and fraud rather than expose themselves to the publicity attached to legal proceedings. The irregularities of which the National Bank was accused were by no means grave, and M. van Zeeland's share in the responsibility for them was not of such a nature as to call for censure.

(6) M. van Zeeland's Resignation

Notwithstanding this, the affair of the National Bank provided a long-awaited opportunity for M. Degrelle and M. van Zeeland's other opponents to launch out a concentrated attack on him. The corruption prevalent in the Belgian Press facilitated their task to no slight extent. Big money changed hands towards the end of August, 1937, and M. van Zeeland's opponents succeeded in working up a sweeping Press campaign of mud-flinging. The importance of the alleged irregularities was exaggerated out of all proportion to their real significance, and M. van Zeeland was represented as the villain of the piece. At the same time at least one of M. van Zeeland's colleagues in the Cabinet was doing his best to stab him in the back.

M. van Zeeland could have afforded to ignore this mud-flinging campaign. Politicians on the continent have to be hardened to that sort of thing, especially as the law of libel

in most continental countries is not nearly so strict as in Great Britain. The right course for M. van Zeeland was to let the artificial storm of indignation blow over. After a while the Belgian public would have been able to see the alleged irregularities in their true perspective, notwithstanding the campaign of exaggeration by M. van Zeeland's opponents and by bribed newspapers. His sensitive nature did not allow him to take this course, however, and he decided to resign the Premiership. A few days later he even resigned his seat in Parliament, on the ground that he wanted the judicial inquiry to proceed unhampered by his official position. Once more he allowed himself to be guided by chivalry towards his opponents.

M. van Zeeland's opponents were, of course, triumphant. They had succeeded in removing him from office. The United Front, which commanded a formidable majority in Parliament and in the country, appeared to be broken. It looked as though M. Degrelle had his chance.

The political prospects were very gloomy indeed. For weeks it was impossible to form a Government. While M. van Zeeland's authority and skill had succeeded in keeping the three leading parties together, it looked as though none of the lesser politicians who should have succeeded him in his position would be able to do so. One after another the political leaders entrusted with the task of forming a Cabinet had to give up the attempt.

(7) Flight from the Belga

It was inevitable that M. van Zeeland's resignation and the political deadlock that followed it should react upon the belga. A sweeping flight of capital began, and the National Bank lost a substantial amount of its published and unpublished gold holdings. Once more, deposits were being withdrawn from the banks, as they had been in March 1935. It looked as though history were about to repeat itself. In these circumstances, many of those who were influenced by the mud-flinging campaign against M. van Zeeland began to realise the mistake they had committed in hounding that great statesman from office. Under the pressure of public opinion, even some of the newspapers began to play a different tune. Voices were raised demanding the return of M. van Zeeland. In the past, when he had been exasperated by uncompromising opposition into tendering his resignation, he had always been persuaded eventually by the King or the political leaders to

retain his post. On the present occasion, however, he was adamant, for he felt that his honour was at stake. A solution had to be found without him.

There was a fundamental difference between the situation of March 1935 and that of October 1937. In March 1935 the depreciation of the belga was largely due to the fundamental disequilibrium due to its gross overvaluation. As a result of the devaluation, this disequilibrium disappeared. Even though the sharp depreciation of the franc during the summer and early autumn of 1937 could not but embarrass Belgium, the pressure due to it was by no means intolerable, especially as internal prices and costs in France were rising rapidly. This pressure, together with the flight from the belga due to political uncertainty, might well, however, have proved fatal. The withdrawal of foreign refugee money was accompanied by a flight of Belgian capital, partly in anticipation of a depreciation of the currency and partly for fear of Socialist legislation on the part of M. van Zeeland's successor. These fears were particularly strong so long as there appeared to be a chance that M. de Man, Finance Minister in M. van Zeeland's Cabinet, would become Prime Minister. M. de Man, before his advent to office, had been the author of Radical schemes of expenditure on social reform and public works, but M. van Zeeland's statesmanlike wisdom had put a brake on their application. It was feared that if M. de Man became Prime Minister he would apply at least some of his earlier schemes. He was, however, unable to obtain the support necessary to form a Government, mainly because his attitude during the latter part of M. van Zeeland's régime had been subject to much criticism on the part of M. van Zeeland's supporters.

(8) End of the Crisis

When it became evident that someone with moderate views was likely to succeed M. van Zeeland, the fears became allayed to some extent. At the same time the accentuation of the dollar scare diverted attention from the belga, and the general international financial uncertainty induced many Belgians to refrain from sending their capital abroad. The flight from the belga came to an end even before the Cabinet crisis was solved through the formation of a Government by M. Spaak, former foreign Minister in M. van Zeeland's Cabinet. The termination of the prolonged Cabinet crisis finally set the minds of the public at rest—at any rate for the time being. It

failed, however, to restore the optimism of the foreign exchange market towards the belga. Until the late summer of 1937 the forward belga was quoted almost constantly at a premium, indicating the optimistic views of the market about the prospects of Belgium and of the Belgian currency. During the attacks that preceded M. van Zeeland's resignation, the forward belga went to a discount, which became considerably accentuated as a result of the speculative attacks that followed his resignation. Even though the solution of the Cabinet crisis resulted in the covering of many bear positions, the forward belga remained none the less at a discount which was proportionately wider for long periods than for short periods. This was due to the widespread feeling that even though M. Spaak had succeeded in forming a Government, the prospects of lasting political stability were none too bright. It seemed doubtful whether, in the long run, anyone but M. van Zeeland would be able to keep the parties of the National Union together. The possibility of a series of Cabinet crises at frequent intervals, and of an eventual deadlock, giving M. Degrelle his chance, could not be ignored. The only hope of avoiding it was the return of M. van Zeeland. Possibly when things become really dangerous for Belgium, the nation will realise the necessity for calling him back, and M. van Zeeland will realise the necessity of answering the call.

CHAPTER XXXVI

THE COMEDY OF SILVER

(1) The Case for Remonetisation of Silver

The belga scare was followed by another minor scare, this time in the silver market. While the belga scare was the result of a political tragedy, the silver scare that followed it was the outcome of a political comedy—in fact, one might almost call it a farce. Admittedly, the situation created by the mismanagement of silver was not without its tragic elements. We saw in Chapter XXIV how President Roosevelt's ill-advised policy of raising the price of silver led to a major crisis in China. At the same time it is difficult to trace any other financial subject which could provide such excellent material for a farce as the history of silver during the last few years.

During the period of gold shortage, there was a strong case for a partial remonetisation of silver at a reasonable price. Even now that the gold shortage has ceased, there is everything to be said in favour of curing the maldistribution of gold through the replacement of part of the huge American gold reserves by a corresponding stock of silver. Unfortunately, exaggeration and greed have very nearly wrecked a perfectly good case. President Roosevelt was persuaded to embark upon a course which, in the long run, was bound to produce a highly damaging result, not only to the community as a whole—which would have been a secondary matter from the point of view of some silver interests—but upon the silver interests themselves. This subject is dealt with in detail in my *Monetary Reform in Theory and Practice,* Chapters XXVII and XXVIII. I propose here to summarise the developments that led to the silver scare of 1937.

When President Roosevelt assumed office in 1933, he was determined to reflate by every means at his disposal. One of the means was the expansion of the metallic basis of credit by the inclusion of silver. To that end, legislation was passed in 1934 by which silver was admitted to form part of the metallic reserve to the extent of 25 per cent of the total metallic

stock. Since the official holdings were a mere fraction of this percentage, privately owned silver stocks were nationalised and the Treasury began to purchase silver on a large scale both at home and abroad.

(2) Silver Group's Fateful Influence

So far, so good. Had the United States authorities confined themselves to buying up the silver that came to the market at a reasonable price, their policy could only have produced a beneficial effect. The American silver stock would have been raised gradually to the statutory limit, and the price of silver would thus have been maintained stable at a figure which secured a good profit to producers. This was not, however, sufficient for the powerful silver group in the United States, which exercised such a fatal influence upon President Roosevelt's silver policy. Senator Pittman and his followers succeeded in forcing the President to have legislation passed to provide that the price of silver should eventually be raised to $1.29, which was about three times the world market price prevailing at the time of the initiation of the silver purchases on a large scale.

There was no justification, economic or moral, for the proposed revaluation of silver, and those who advocated it argued that to raise the price of the metal that served as the currency for so many hundreds of millions of people in China and other parts of Asia and Africa would mean a corresponding increase of the purchasing power of the peoples concerned, and that this would lead to a revival of world trade. They overlooked, deliberately or otherwise, the elementary fact that to raise the value of a currency implies deflation, and that this was likely to inflict depression and crisis upon the silver-using nations, especially China. This ought to have been obvious from the very outset, and if it was overlooked by those advocating this artificial increase of the price of silver, this was either because the partisans of that policy were blinded by their fanaticism—and it is difficult to imagine anybody more stupidly dogmatic and fanatical than a silver crank—or else they were concerned only with pursuing their own selfish ends. They got their deserts through the disastrous failure of the policy they advocated. Unfortunately, the heavy hand of Nemesis fell on guilty and innocent alike; in fact, the guilty were let off comparatively lightly, since up to the time of writing the price of silver has been maintained at a remunerative figure. It would not be surprising if the final

outcome of the ill-advised and mismanaged policy were a depreciation of the metal far below the level from which President Roosevelt raised it.

(3) Hopeless Attempt to Bolster up Silver

It was obviously hopeless from the very outset to attempt to maintain the price of silver at $1.29, even if it were raised to that level. At that figure the production of silver would become extremely profitable and the output would increase enormously. This was duly realised by every Government with the exception of the Washington Administration, and one country after another decided to abandon silver, even as an auxiliary currency. Had the silver interests exercised wise moderation, it might have been possible for President Roosevelt to persuade the British Government to fall in line and co-operate in maintaining silver in the vicinity of, say, 45 cents. The British lead would probably have been followed by other Governments. It was, however, inconceivable that any sensible statesman should, for the sake of pleasing President Roosevelt, incur heavy losses to his Treasury by helping the United States to bolster up silver at a level at which, in the long run, it was bound to prove untenable. The decision to raise the price of silver deliberately and artificially ruled out the possibility of its re-monetisation by any country other than the United States. In fact, it was bound to lead to the demonetisation of the metal in silver-using countries. So long as the United States authorities were foolish enough to pay an excessive price for silver, it was very tempting to unload the metal upon them. This was, in fact, done on a fairly large scale, notwithstanding the agreement for the limitation of the sales of silver concluded during the London Economic Conference of 1933.

The immediate effect of the initiation of President Roosevelt's silver-buying policy was a sharp rise in the price of silver through speculative purchases. This rise was actually encouraged by the United States authorities, who gradually raised their internal buying price to show that they really meant to raise the price of silver to the statutory figure of $1.29.

(4) Speculative Boom followed by Slump

The experience of President Roosevelt's gold-buying policy of 1933–34 repeated itself. Although the high price was paid for American-mined silver only, the price in the London silver market was constantly chasing the American parity, even

though no arbitrage was possible on the basis of the internal American price. Speculators were buying silver recklessly, on the assumption that sooner or later the United States authorities would be willing to buy large quantities in the world market, since the American supply in itself was not sufficient to enable them to raise their silver stock to the statutory proportion of 25 per cent of the total metallic reserve.

Throughout the first half of 1935 a huge bull position in silver developed, and the London price rose to 36*d*. During the summer of 1935 a reaction set in. In order to moderate the relapse, the United States Treasury had to step in and support the market. Ever since June 1935 the United States Treasury has been practically the only large buyer of silver, while everybody else has been selling. The silver market became wholly artificial and one-sided, and the price was pegged by the American authorities, who at times had to buy huge amounts. Eventually, in December 1935, the Washington Treasury grew tired of supporting the market at an excessive price and allowed the price to find its level. There was a disastrous slump from over 29*d*. to under 20*d*. For a while the Washington authorities withdrew their support from the London market completely, even though they continued to buy substantial amounts from silver-producing countries and from China.

After the painful liquidation of speculative positions, the price of silver settled down in the vicinity of 20*d*. Fluctuations were narrow during 1936 and the first eleven months of 1937. The undertone, however, was distinctly weak. The bulk of the supplies that came to the London market were taken by American banks for sale to the Washington Treasury at the latter's buying price of 44$\frac{3}{4}$ cents. The position was one of uneasy equilibrium. Most people realised the artificial character of the market, and wondered at times how long the United States authorities would be prepared to continue to carry single-handed the whole burden of silver valorisation.

(5) Fresh Wave of Uneasiness

The vague uneasiness about the prospects of silver began to assume a more concrete form during the autumn of 1937 as a result of heavy Chinese exports of silver to London. Although it was known that the United States Government was prepared to buy Chinese silver, the arrival in London of large consignments of silver from Hong Kong gave rise to fears that part of it, at any rate, would be forced on the

London market. It was understood that the London refineries were working overtime to refine the Chinese silver, which had arrived here mostly in the form of coins. This gave rise to rumours that the silver was being refined in order that it should be good delivery in the London market. As a matter of fact, the reason why it was being refined in London was that the American refineries were already working to the limit of their capacity.

Another factor which accentuated the uneasiness about silver, and which eventually led to the silver scare of December, was the termination of the agreement of 1933 for the limitation of the sales of silver. Some shrewd speculators and producers were aware of the fact that the agreements were due to expire at the end of 1937, but the majority of market operators had overlooked it until it was brought to their attention by the Press, which informed them that no negotiations had been entered into for the renewal of the expiring agreements. Even though the significance of the agreement of 1933 had declined considerably, its non-renewal produced a profound psychological effect and brought about a heavy drop in the price of silver to the vicinity of 18½*d*. At that price it was highly profitable for arbitrageurs to ship silver to the United States and sell it to the Washington Treasury. Owing to the uncertainty of the outlook and the limitation of refining facilities, arbitrageurs were, however, reluctant to commit themselves to any large extent.

(6) Unpromising Prospects

Following upon the slump of silver, Mr. Morgenthau made a statement denying that the Administration intended to discontinue its silver-buying policy. As usual, however, his denial was not water-tight. He made no reference to the price at which the United States authorities were prepared to continue their silver purchases. The market was kept on tenterhooks until the New Year, when it became evident that the Washington authorities were going to continue to buy imported gold at 44¾ cents, even though the price for home-produced silver was materially reduced at the end of the year. The arrangements for the purchase of newly produced silver from Mexico and Canada were renewed and the willingness of the United States authorities to absorb Chinese silver exports was also reaffirmed. As a result, bear positions were covered and calm was restored in the silver market. It was nevertheless felt that, since the Washington authorities

were in a position to lower their purchase price at any moment, the outlook was anything but reassuring.

The fact that President Roosevelt dared to reduce the price for American-produced silver showed that the political influence of Senator Pittman's silver group was no longer what it had been. There was indeed no reason why the American silver producers should receive a free gift in addition to the world price which was high enough to enable them to make a fair profit, especially if for their undertakings silver was merely a secondary product. The chances are that sooner or later the internal American price will be reduced to the level of the world price, and that the latter will also be allowed to decline to a level at which the market will be more or less self-supporting. It ought to be borne in mind that, on the basis of the existing legislation, the United States cannot afford to absorb silver indefinitely. Even though the present proportion of silver to gold is not anywhere near the statutory 25 per cent, it should be remembered that the greater part of the gold stock represents the counterpart of "hot money", which is likely to be withdrawn sooner or later. In fact, in the absence of an export surplus or a fresh influx of capital, the import of silver is likely to be accompanied by a corresponding outflow of gold. Thus in the course of a number of years a stage will be reached when the Washington authorities will no longer be buyers. It is true that silver hoarding in the East might revive, but even allowing for this and other potential sources of demand, the chances are that in the long run the world price will decline below its present level.

CHAPTER XXXVII

ANOTHER FRANC SCARE

(1) Socialists Exercise Moderation

It was appropriate that the year of many scares should close with another franc scare. The improvement in the franc that set in during October and continued during November was indeed too good to last. It was based not so much upon any improvement in the financial or economic situation as upon the truce between the parties and classes. This truce gave the Government a breathing-space. So long as it continued, there was no need to fear a relapse. It was, however, an uneasy truce. There was a widespread feeling that either the Right or the Left might at any moment resume hostilities.

Throughout October and November the predominant majority of Socialists, and even Communists, behaved with commendable moderation. They appeared to have realised that it was necessary to have a stable Government in face of the international political tension, and of the vulnerability of the franc. The number of strikes was not excessive, and stay-in strikes had ceased altogether. Although M. Jouhaux and other labour leaders indulged from time to time in aggressive remarks, their behaviour on the whole indicated a higher degree of self-restraint than could possibly have been hoped for. It looked as though the calm period and the moderate recovery might continue well into the New Year.

(2) Concerted Attack from the Right

The very moderation of the parties of the Left, however, encouraged the Right to take the offensive. Towards the middle of December the Government was unexpectedly subjected to a barrage of criticism on account of its budgetary policy. A writer with leanings towards the Right, M. Henri Michel, published a book entitled *France, Prends Garde !*, in which he argued with great force that M. Bonnet's attempt to balance the budget and save the franc was doomed to failure. His arguments, and the array of figures with which he supported them, were very impressive, even though the

author's name did not carry sufficient weight to make a really considerable stir. This deficiency was counterbalanced by attacks on the Government by MM. Flandin and Reynaud. Both being former Finance Ministers, their word carried considerable weight with the French public, and also abroad. Almost simultaneously they published articles in which they denounced M. Bonnet's budget figures as being much too optimistic. They declared that the ordinary budget was very far from being balanced, and that the Treasury would have to borrow during 1938 something between 40 and 50 milliard francs.

There can be no doubt that the pessimism of MM. Michel, Reynaud and Flandin was to a large degree justified. M. Bonnet overestimated the probable increase of revenue and the probable effect of his economy measures. Nevertheless, it was difficult to see what was to be gained by rubbing in and exaggerating these facts. M. Michel, at any rate, contributed a concrete proposal for the solution of the problem by suggesting that the Government should carry out a forced conversion in order to save interest on the public debt. MM. Reynaud and Flandin, on the other hand, confined themselves solely to destructive criticism and vague platitudes about increasing production and restoring confidence. It is impossible to escape the conclusion that the whole campaign was aimed at embarrassing the Government, in the hope that as a result of a financial crisis M. Chautemps might be forced either to resign or to reconstruct his Cabinet and to include in it politicians of the Right. Such shrewd experts as MM. Reynaud and Flandin could not for a moment doubt that their attacks would lead to a franc scare.

(3) Effect of Attack

The effect of these attacks—especially that of M. Reynaud in the Chamber during the budget debate—was accentuated by the circulation in London and other centres of M. Michel's book and the periodicals containing the articles by MM. Reynaud and Flandin. Copies were sent from Paris to bankers and financial journalists, with the pessimistic passages specially marked. To a large extent these copies were circulated anonymously. There can be no doubt that this was done by interests engaged in bear speculation against the franc. The effect was a heavy selling pressure on the franc, which had to be met out of the newly acquired resources of the French Exchange Stabilisation Fund. From time to time the discount on the forward franc widened considerably.

The franc scare reached its climax when M. Reynaud repeated his arguments with increased emphasis in the course of the budget debate in the Chamber. It looked as though the parties of the Right were determined to bring the truce to an end, and test their strength against the parties of the Left. The latter were not slow to retaliate ; realising that the franc was being attacked as a means of political pressure, the Socialists resumed their agitation in favour of exchange restrictions. MM. Chautemps and Bonnet were determined to maintain the freedom of the exchanges, but judging by the temper of the Socialists, aroused by the attacks of their political opponents, it seemed probable that if they were unable to defend the franc any longer, M. Blum would want to resume office and would in that case immediately impose exchange restrictions.

(4) Franc Scare Subsides

When the Socialists duly showed their hand, the campaign of the Right against the budget, the franc and the Government stopped as suddenly as it had begun. A few days after his militant speech, M. Reynaud, with the predominant majority of his political followers, voted for the passing of the very budget which he had been denouncing with such emphasis. Indeed, the Chamber passed the budget with a record majority. M. Reynaud, by his attitude, lost for a time much of the prestige which he had acquired in France and abroad through his courageous advocacy of the devaluation of the franc in earlier years.

With the passing of the budget, the tension eased, though the undertone remained doubtful. In order to assist in the recovery, M. Bonnet disclosed the fact that since the beginning of October the French Exchange Stabilisation Fund had acquired gold and foreign exchange to the equivalent of 10 milliard francs. This amount was well above market estimates. Had it been announced at a time when the undertone of the franc was firm in any case, it would have accentuated the pace of repatriations. As it was, the announcement fell rather flat. This example shows that the secrecy that surrounds Exchange Equalisation Account operations is not necessarily beneficial.

(5) Labour Troubles

M. Bonnet's announcement nevertheless served the useful purpose of moderating the revival of selling pressure caused

by labour troubles during the last week of the year. It is difficult to see to what extent the campaign of the Right was responsible for the revival of labour unrest, but there can be no doubt that the moderates of the Socialist party would have been in a better position to keep their followers in check had it not been for the unfortunate offensive taken by MM. Flandin and Reynaud. As it was, they lost control over a large section of the workmen of Paris, and during the Christmas holiday the French capital witnessed a number of strikes affecting the vital services. It was inevitable that these disturbing events should lead to a fresh weakness of the franc. Fortunately, M. Chautemps handled the situation with a remarkably firm hand. The essential services of transport and distribution were maintained with military aid, and the workmen of the public utility services were compelled to return to work unconditionally, on the promise that their grievances would be considered. The year thus ended with a somewhat more optimistic tone, since the firm action taken by the Government indicated that the promise made by M. Chautemps in the Rambouillet declaration of October, to maintain industrial discipline, was being carried out.

The experience of December showed, however, how precarious the position of the franc was, and how essential it was to continue the truce. Any attempt by either of the parties to manœuvre for position was bound to lead to similar moves by their opponents. The only way to maintain the improvement achieved since October was to refrain from any aggressive movements.

(6) The 40-hour Week

The report of the committee appointed to examine the problems of the 40-hour week and of production in general, provided, in fact, an excellent basis for the continuation of the truce. It fully upheld the principle of the 40-hour week, but provided for a considerably increased elasticity in its application. Thus overtime was to be allowed in the case of seasonal pressure, of industries connected with national defence, and, what was more important, of every undertaking which was in arrears with its deliveries. This latter clause made overtime admissible in every instance where it was needed. After all, no industrial undertaking was likely to want to pay overtime at 25 per cent above the normal wage rates unless it was to make urgent deliveries. Although it remained to be seen how the report, the findings of which were accepted in

principle by both parties, would work in practice, it certainly held out hopes for the much-needed increase of production. The realisation of this fact was largely responsible for the calmer atmosphere in which the franc closed a highly eventful year.

PART IX

THE SITUATION IN 1938

CHAPTER XXXVIII

GREAT BRITAIN WEIGHS HER GOLD

(1) Excessive Optimism

At the turn of the year, there was little cause for rejoicing anywhere. Apart altogether from the international political outlook, which was in itself sufficient to cast a gloom over the five continents, the economic position and outlook itself deteriorated materially in most parts of the world during 1937. Most people were inclined to exaggerate rather than minimise the adverse factors making for depression, and in doing so they materially helped to accentuate the adverse trend. To some extent Great Britain kept aloof from this world-wide wave of pessimism. Even though indications of a coming depression were not lacking, opinion was divided as to whether the country was really in for a bad time. The fact that, owing to rearmament, the steel industry was still working to the limit of its capacity and that the ship-building industry was prosperous, producing a fair demand for coal, reduced the extent to which the trade depression in the United States reacted upon British trade. The British public is not inclined to fall into extremes to anything like the same extent as the American public, and the psychological factor which threatened to magnify the trade recession into a major depression was not operating to the same extent in Great Britain as in the United States. The British character never knows when it is beaten, and this quality certainly helped towards weakening the adverse conditions.

Beyond doubt, disinclination to give way to exaggerated pessimism is a highly valuable quality. At the same time, however, there is such a thing as virtue overdone, and excessive optimism is not always necessarily helpful. In one respect, at any rate, Great Britain is guilty of such excessive optimism, namely in respect of her gold position.

(2) Increase of Gold Reserve

In the course of the last few years, the British authorities have succeeded in accumulating a remarkably large gold stock.

This was contrary to British tradition, according to which the stability of the world's banking centre, London, was secured to the extent of 75 per cent by universal confidence and only to the extent of 25 per cent by gold. Before the war London was accustomed to work with a very narrow margin of gold reserve above the indispensable minimum, and this custom was retained after the war. Even before 1914, when London's lead as a banking centre and Great Britain's lead as a lending country were indisputable, several countries had much larger gold stocks than Great Britain. After the war, too, during the period of stability, the British gold stock was overshadowed by the gold stocks of the United States and France, and even of debtor countries such as Germany, or countries of secondary importance such as Spain. This was taken as a matter of course in London, in the same way that it was taken for granted that while a continental bank ought to keep a cash ratio of 25 per cent, for a British joint stock bank a cash ratio of 10 per cent was ample.

The present generation, having been brought up in this tradition, regarded the accumulation of the official British gold stock from 1932 onwards with pre-1931 eyes. Forgetting that the events of 1931 proved that the gold reserve was hopelessly inadequate, they compared the figures of the growing gold reserve with those of pre-crisis days, when £130 million was regarded as a normal amount. Even though until 1937 the Exchange Equalisation Account did not publish its gold figures, the increase in the gold stock of the Bank of England and the estimates of the gold holding of the Exchange Equalisation Account created a widespread impression of technical strength. Few people realised the fact that the increase of the gold stock was to a large extent offset by a corresponding increase of foreign funds invested in Great Britain. It could not be otherwise, since between 1932 and 1935 the British balance of payments was barely at equilibrium, while during 1936 and 1937 there was a large and growing trade deficit.

(3) Exchange Equalisation Account's Gold

It is true that to some extent repayments of foreign loans and credits may have exceeded new lending, but on the other hand British investments in Wall Street probably exceeded repatriations of British capital. The only item which increased the gold stock without a corresponding increase of London's foreign liabilities was the profit of the Exchange Equalisation Account, made as a result of the gradual depre-

ciation of sterling between 1932 and 1935. To the extent to which the authorities bought their gold at a price below its present level, they made a profit at the expense of foreign owners of sterling, whose assets had depreciated in terms of gold to a corresponding extent. Although no figures are available, it would be a mistake to overestimate the extent of these profits. After all, by far the larger part of the Exchange Equalisation Account's gold was acquired after March 1935, since when sterling had been more or less stable.

The wave of optimism aroused by the evidence of a growing gold reserve received considerable stimulus as a result of the publication of the actual amount of gold held by the Exchange Equalisation Account. It is one thing to assume that the Exchange Equalisation Account holds large amounts of gold and quite another to be told officially the exact amount which it holds. Sir John Simon's announcement in June 1937 that at the end of March the Exchange Equalisation Account held gold to the amount of £186·7 million was followed by a wave of over-buoyant optimism, which became further accentuated on the official announcement, at the end of December, that by September 30, 1937, the Exchange Equalisation Account's gold stock had increased to £279 million. Since the boom-like optimism had been disposed of by the gold scare and the various other scares, this dose of optimism was not in itself a bad thing—up to a point. It was apt to cause more harm than good, however, because it created a feeling that this country could well afford to lend and spend more abroad.

(4) Agitation in Favour of Lending Abroad

Following upon the publication of the gold figures, a widespread agitation developed in favour of resuming free, or comparatively free, lending abroad. The possession of a large gold stock conveyed the impression that this country was once more in a position to grant loans to credit-worthy foreign borrowers. The fact that the counterpart of the gold stock existed in the form of foreign " hot money " in London, liable to sudden withdrawal, was entirely overlooked by those who launched this campaign. Their number included academic economists and bankers. The former still believed in the nineteenth-century superstition that in some mysterious way the granting of foreign loans would lead to an increase of British exports, even if no provisions were made to compel the borrowers to spend the proceeds in this country. This superstition dies hard, and it may be several generations

before the whole problem of trade balances and overseas lending becomes adequately " debunked ". Some of the bankers who agitated in favour of a resumption of lending abroad were not altogether disinterested in the matter. Before the crisis, profits on foreign loan operations constituted the main part of the earnings of their banking houses. It is true that the loans they issued at such a profit to themselves were wholly or partially defaulted upon almost without exception. Nevertheless, this was no reason for the bankers concerned not to agitate in favour of the resumption of the issue of foreign loans, upon which they could once more earn big commissions, and which would, of course, also be defaulted upon in due course.

The evidence of the possession of liquid resources in the form of a large and increasing gold stock assisted to no slight degree the campaign in favour of the resumption of lending abroad. Fortunately, the Government was wise enough to resist the pressure. Even though early in 1938, following upon the publication of the van Zeeland report, it relaxed the embargo to some slight extent, loans for foreign Governments, Corporations and other publicly-owned undertakings continued to be subject to the old restrictions. Only one recent exception was made to this rule, and that was in favour of Belgium. The inadequate response to the Belgian loan issued in December 1937 indicated that, apart altogether from the official attitude, the market and investors themselves were not yet ready for the resumption of lending abroad.

(5) Huge Trade Deficit

While the authorities fully realised that they could not afford to re-lend their newly acquired gold, they displayed less wisdom as far as the spending of the new resources upon imports was concerned. Throughout 1936 and 1937 the deficit of visible trade was growing at an alarming rate. The import surplus amounted to £275 million for 1935; it increased to £347 million for 1936, and to £432 million for 1937. Admittedly, to some extent the increase of the deficit may have been counteracted by the increase of invisible exports, especially earnings of shipping and the yield on foreign investment. Even allowing for this factor, the growth of the adverse trade balance was alarming. It failed, however, to alarm British public, expert or even official opinion. As in the case of lending abroad, the nineteenth-century conception that an increase of the import surplus was a Good Thing continued

to reign supreme. It is really amusing to see the headlines in the London Press after the publication of the monthly trade figures. In any other country the evidence of a growing import surplus would have been regarded as an alarm signal and would have given rise to agitation in favour of measures to counteract the tendency. In the British Press, however, it was simply represented triumphantly as a proof of the improvement of trade. Month after month it was cheerfully announced that imports had increased by so many millions of pounds. It is as if an individual were to celebrate the fact that he had succeeded in spending more than his income. Few people realised that as a result of the growing import surplus a considerable part of the gold which should have been kept to meet withdrawals of "hot money" was being spent on current requirements.

(6) Living in a Fool's Paradise

Admittedly, to a very large extent the increase of the import surplus was the inevitable consequence of rearmament. This was, however, no reason why the authorities should not make a supreme effort to keep down the trade deficit as much as possible. No pressure was brought to bear upon them, however, either by the public or by the Press. The necessity for it was not realised. Everybody was living in a fool's paradise, counting with satisfaction the growing gold reserve and blissfully oblivious to the fact that the negative gold reserve represented by "hot money" was rising even faster.

One of the reasons for this unwarranted optimism was the absence of any statistics of the negative gold reserve. The Bank of England, it is true, compiles figures concerning London's short-term foreign assets and liabilities, but these figures are not published. While in the United States the statistics of "hot money" are published at regular intervals, in Great Britain they are not available to anybody except a few bank officials and Treasury officials. In any case, the figures are far from complete. No attempt has been made to compile figures about foreign long-term investments in this country, even though they are probably far in excess of short-term investments.

(7) Need for Stimulating Exports

Notwithstanding the absence of pressure of public opinion, the authorities might have realised the necessity for attempting to counteract the rapid rise of the import surplus, instead

of submitting to it with Oriental fatalism as being the inevitable consequence of rearmament. There are many means at the disposal of the authorities for improving the trade balance. They might try to persuade the United States authorities that a depreciation of sterling was essential in order to maintain equilibrium. They might resort to the method of subsidies, which is practised by almost every rival country. Above all, they might adopt exchange clearing in relation to countries with an unduly large export surplus to Great Britain. Until now, exchange clearing has only been adopted in cases when British commercial creditors have found it difficult to collect their claims. Apart from this, countries with an export surplus to Great Britain were left in undisturbed possession of the sterling proceeds of their exports. Since Germany, Italy and other countries were trading with these countries on a basis of bilateralism, many orders were diverted from Great Britain to her rivals. Even if British goods were better and cheaper, foreign countries placed their orders with Germany because this was the only way in which they could be paid for their exports to Germany. The only way in which it would be possible to meet this method of competition is by the adoption of the same method, to enable the British export trade to hold its own. Admittedly, this is very much contrary to the deeply rooted principles of *laissez-faire* that continue to reign supreme in Great Britain. So long as the growing gold stock creates a false feeling of technical strength, nineteenth-century prejudices are not likely to be overcome. Only when the tide of gold movement turns, and the British authorities see themselves compelled to make an effort to improve the trade balance, will the necessity for fighting Britain's business rivals with their own weapons be realised. In the meantime, the growing trade deficit continues to make heavy inroads in the gold stock, notwithstanding the increase of the latter through further capital movements to London.

(8) The Anglo-American Trade Negotiations

The false conclusion inferred from the evidence of Great Britain's growing gold stock is highly detrimental to Great Britain also from another point of view. The erroneous belief that the technical position of the pound is unassailable has materially weakened Great Britain's bargaining position in relation to the United States. It is obviously to the interest of the United States that Great Britain should be in a position to maintain the stability of sterling without undue difficulty.

The experience of 1931–33 made it evident that the over-valuation of sterling might lead to developments which would be bound to react unfavourably upon the United States. But for the evidence of a large and increasing gold stock, it might have been possible to persuade the United States authorities to agree to a lower sterling–dollar rate. Alternatively, it might have been easier for the British negotiators to persuade the United States negotiators to agree to a material reduction of the adverse British trade balance in relation to the United States. As it is, in face of the growing British gold stock the United States authorities may feel justified in driving a hard bargain with Great Britain.

Thus the nominal increase of the gold stock, far from strengthening the technical position of Great Britain, tends to weaken it materially. For the moment, the continued influx of funds from abroad camouflages the real state of affairs, but sooner or later the truth will be realised.

CHAPTER XXXIX

PRESIDENT ROOSEVELT'S DECISION TO REARM

(1) No Further Concessions to Business

The turn of the year found the United States in the middle of the much-feared trade depression. By the end of 1937 the steel output had declined to something like 20 per cent of the total capacity of the industry. General Motors decided to reduce their output drastically, and to dismiss many thousands of employees. Unemployment in the United States was estimated to have increased by something like 1½ million during October and November. While economic experts were debating whether or not a major depression was coming, the major depression actually arrived.

These developments were regarded with mixed feelings in banking and business circles. To a large extent they were the result of the Rich Men's Revolt, which aimed at forcing the Administration to abandon New Deal legislation. There was no lack of triumphant croaks of " I told you so ", and in many quarters in Wall Street and thereabouts the Government's discomfiture was viewed with much satisfaction. In most cases, however, the satisfaction was marred by losses suffered through the Wall Street slump and the trade setback. Indeed, most participants in the Rich Men's Revolt paid a heavy price for the satisfaction which they derived from its result.

Moreover, contrary to anticipations, President Roosevelt refused to grant any further concessions beyond those granted during the autumn in an attempt to disarm the opposition of capital and enterprise. In fact, since the more conciliatory attitude adopted during October and November did not seem to check the downward trend, towards the end of the year the Administration spokesmen changed their tone. Several statements definitely hostile to business were made by President Roosevelt's lieutenants, and it was generally expected that, having realised the futility of its half-hearted policy of conciliation, the Administration would revert to the policy of the big stick. It was feared that the year 1938 would witness the introduction of a new series of anti-capitalist measures.

In the circumstances, President Roosevelt's New Year message was received with a certain amount of relief. Although it was not lacking in threats against capital and enterprise, the President went out of his way to emphasise the fact that he was opposed not to capital as such but to the improper use of capital. His message foreshadowed no general anti-business measures, but the reinforcement of anti-trust legislation and of taxation directed against speculative profits. In other words, the attack was directed not against the whole vast business community but against the "60 families", a term which was rapidly becoming as general in the United States as the catchword "200 families" became in France during 1935 and 1936.

(2) The Disunited States

At the beginning of 1938, in face of the threatening economic crisis, the people of the United States were hopelessly disunited. There was, on the one hand, the class of employers, refusing to concede to labour the rights which it had possessed for many years in Great Britain. On the other hand there was the labour movement which, encouraged by the French example and stimulated by the infiltration of Communist elements in its management, sought to take advantage of the friendly attitude of the Administration in order to obtain more concessions than the industries could support in existing circumstances. Attempts were made to adopt the tactics of the French sit-down strikes. These attempts were met by the reinforcement of the brutal methods of strike-breaking for which American industrial employers are notorious. The administration sought to hold the balance between the two extremes, but it was definitely inclined to favour labour at the expense of capital, even though occasionally the executive lent its authority and its armed forces for the ruthless suppression of violent labour disturbances.

Evidently President Roosevelt was determined to maintain in substance his New Deal legislation. Undaunted by the defeat of his Wages and Hours Bill in Congress, he made a new attempt in the New Year to obtain the passing of that legislation. Considering that by that time the trade recession was in full swing, nothing could have been more ill-advised. Faced with the prospects of prolonged depression, industrial undertakings were in any case inclined to reduce their activity. If in addition they were faced with minimum wages and a reduction of working hours, they would have even more reason to

cut down their staff. There can be no doubt that President Roosevelt was right in fostering the progress of social reform in the United States. Unfortunately he chose the wrong moment for it. Had he carried out his legislation while trade was definitely on the upward swing during 1935 and 1936, this would have produced a beneficial effect. Employers could then still have afforded to consent to higher wages, since prices were rising and they had a chance to pass the increased cost on to the consumers. As ill fate would have it, the attempts to obtain minimum wages and maximum hours through the original New Deal legislation were defeated at that time by the decisions of the Supreme Court. By the time the Administration was ready to re-introduce the same measures in a different form, the upward movement of trade had come to a halt.

(3) Inconsistency of Orthodox Monetary Policy with Radical Social Policy

President Roosevelt made a fatal mistake in reverting to monetary orthodoxy at a time when he was determined to pursue a radical social policy. During the second part of 1936 he adopted measures tending to check monetary expansion, and his reversion to monetary orthodoxy culminated in his statement of March 1937 against the rise in commodity prices. He failed to realise that it was only in a wave of prosperity during a period of rising prices and expanding trade that he stood a chance of being able to introduce his social reform measures without inflicting immense harm upon trade and, through trade, upon the very classes which he wished to help.

It may well be asked why it was that there was no Rich Men's Revolt during the earlier years of the Roosevelt régime. Rich men had just as much reason to be dissatisfied with President Roosevelt's legislation in 1935 as in 1937. In 1935, however, they had every reason to hope that they would make a profit in spite of President Roosevelt's pro-labour legislation. By 1937, owing to President Roosevelt's reversion to monetary orthodoxy, doubt had arisen whether it would be possible to obtain larger profits, higher dividends and capital appreciations. While the rich men were willing to put up with President Roosevelt's social radicalism so long as he brought them prosperity, the moment the prospects of a further increase of prosperity disappeared, they decided to revolt against the legislation directed against them.

President Roosevelt realised to some extent the inconsistency of monetary orthodoxy with social radicalism; hence his reversion to a cheap-money policy during the summer and autumn of 1937. By that time, however, it was too late to check the trade setback with the aid of such mild doses of inflation. The poison had penetrated too far, and required much more drastic antidotes. The Roosevelt of 1933 would have taken the bold course of increasing expenditure by additional milliards and at the same time deliberately depreciating the dollar. The Roosevelt of 1937, however, was four years older and much more than four years less vigorous in his monetary policy. He sought to conciliate the hostile business world by paying lip-service to budgetary orthodoxy and by displaying moderation in his relief work schemes. His statements and actions in this respect had a good Press, but they were of little practical use against the growing depression.

(4) Effect of Rearmament Announcement

Towards the beginning of 1938, however, the business outlook improved materially. President Roosevelt, in his New Year message, foreshadowed a substantial increase of expenditure on national defence. Preparations were made to embark upon a really ambitious rearmament programme. The United States joined in the international rearmament race. At the time of writing it is impossible to judge the full extent of additional national defence expenditure. There is reason to believe, however, that it will be on a very substantial scale. After all, Americans are notorious for doing things wholesale.

No country is in a better position to rearm on a gigantic scale than the United States. She has all the money required, for in spite of the spectacular increase of her public debt in recent years her borrowing capacity is enormous. She produces at home almost all the raw materials required, and those which she has to import she can well afford to pay for, thanks to her export surplus and her huge gold stock. Her industrial capacity for rearmament is immense, especially in existing circumstances, when civil requirements have become reduced to a small fraction of the producing capacity. She has a huge reserve of unemployed, which can be drawn upon by rearmament industries. Last but by no means least, she has a vast human material upon which to draw in order to increase the defence forces.

There can be no doubt that American rearmament on a really large scale would definitely turn the tide of trade. The

United States Government could and should cover well in advance its rearmament requirements of various raw materials, and its purchases would reverse the downward trend of commodities. Rearmament orders would affect in the first instance steel and motor industries, upon whose prosperity the welfare of the nation largely depends. The mere announcement of President Roosevelt's intention to rearm was in itself sufficient to lead to a rise of steel output from less than 20 per cent to about 30 per cent of total capacity, an increase of about 50 per cent. It is easy to imagine what effect the actual execution of the rearmament programme would produce. The effect of rearmament would soon make itself felt also in trades not directly connected with rearmament work, and in the course of a brief period the upward movement in trade would once more be in full swing.

(5) Political Repercussions

Above all, American rearmament on a really large scale would result in a world-wide increase of confidence. We have seen in earlier chapters how the war scares led to setbacks, not only in countries which were likely to become victims of aggression but even in distant countries such as the United States. Anything that tends to reduce the war risk is calculated to increase confidence and improve trade. Nothing could possibly contribute to the increase of confidence to such an extent as American rearmament. A specular increase of the defence forces of the United States would strengthen the factors making for peace. There is no need even for the United States to conclude alliances and undertake commitments in Europe. Such a policy would meet with the uncompromising opposition of the isolationists, who are short-sighted enough to believe that the United States could remain democratic even if the rest of the world became enslaved by victorious Fascist dictators.

Even though the United States is sharply divided on the question of isolation, there are no two opinions about the necessity for rearmament. The most extreme isolationists admit that in order to be able to remain isolated the United States must strengthen her defence forces. Once the strength of the armed forces was raised to a level at which they became a formidable factor, the aggressive States would hesitate to embark upon adventures which might eventually lead to American intervention. The experience of the last war is still fresh in their minds. Then, too, it was the declared policy

of the Administration and the majority of the public to keep aloof from the European war. Notwithstanding this, the United States ended by associating herself with the allied powers. Admittedly, it took her nearly three years to reach that decision. It is reasonable to assume, however, that in another world war the United States would not remain neutral for such a long period. The very fact that she was armed to the teeth would increase the possibility and probability of an early intervention. And the barest possibility of the intervention of such a power on the side of the democratic nations would be sufficient to deter the Dictators from aggression.

Insofar as the trade recession in the United States will tend to stimulate American rearmament, it will prove to be a blessing in disguise, not only for the democratic countries of Europe but also for the United States. Another world war would inevitably ruin Europe and would bankrupt most of the foreign debtors and customers of the United States. Compared with such a menace, the loss suffered through the trade recession and the cost of rearmament disappears into insignificance.

(6) New Dollar Scare

During February there was a revival of the dollar scare, largely as a result of the decision of the Administration to limit the extent of sterilisation of additional gold influx. Once more there was a flight of gold, and the phenomena experienced during October and early November 1937 repeated themselves. It was widely believed that the United States would embark upon wholesale inflation, and that President Roosevelt might even decide to devalue the dollar.

On this occasion, however, the devaluation rumours were not allowed to proceed uncontradicted. Both President Roosevelt and Mr. Morgenthau took an early opportunity to issue emphatic denials. At the same time the evidence that the United States was losing gold also tended to restore faith in the dollar and to put a check on the flight to gold. The experience of February 1938 showed, however, that even the dollar was no longer invulnerable.

CHAPTER XL

FRANCE IN FERMENT

(I) Uneasy Equilibrium

The New Year found France in a state which may best be described as one of uneasy equilibrium. In international politics the opposing camps appeared to be balancing each other more or less. There was, however, always a possibility that a definite change of allegiance by a secondary power such as Poland, for instance, might upset the balance. In internal politics the political truce continued, but it was liable to termination at any moment by either the Government's Left Wing supporters or its Right Wing opponents. Economically the depreciation of the franc brought about a distinct revival of trade, but it came to a halt as a result of the world-wide setback, and at the beginning of 1938 it looked as though the cat might jump either way. The stimulus provided by rising prices was more or less offset by the rise in costs through the adoption of the 40-hour week. The stimulus to trade in general provided by the acceleration of rearmament work was more or less neutralised by the lack of adequate financial resources. Social equilibrium was equally precarious. The burst of labour troubles, which was a natural reaction from the orgy of deflation inflicted upon the working classes until 1936, was followed by a calmer period. It was nevertheless evident that, like the political truce, the social truce might come to an end at any moment, either through a fresh wave of strikes and violence on the part of labour or through some attempt on the part of employers to regain some of the lost ground. M. Chautemps, it is true, was determined to enforce discipline in industry. His ability to do so depended largely upon the continuation of the political and social truce. Financially the Treasury was only just able to meet all its requirements, and had to draw upon the Bank of France in order to repay the London credit. The franc was maintained, but its maintenance was by no means easy.

(2) Political Loans

Wherever one looked, there were storm clouds on the horizon. The international political situation was becoming gloomier every month. We are not concerned with its purely political aspects, but the international political situation gave rise to important financial problems which deserve attention. Throughout the post-war period, France had pursued the policy of building and maintaining a chain of alliances in Central and South-Eastern Europe by granting financial support to impecunious Governments. She could well afford to do so, especially during the prosperous years that followed the stabilisation of the franc. During the last few years, however, France has hardly been in a position to lend abroad. With her declining gold reserve, she has had herself to consider. From this point of view alone, the prolonged defence of the franc at an overvalued level and the inadequate degree of its eventual devaluation produced a highly detrimental effect. Had France devalued, say, in 1935, she would have been in a position to continue her political loans without the least difficulty. As it was, she had to cut down those subsidies just at the time of the growing German and Italian influence in Central and South-Eastern Europe. Thus while France wasted milliards of francs on maintaining alliances when they were superfluous, she could ill afford to continue to finance her allies to a sufficient extent at a time when their allegiance was becoming a matter of real importance.

In this respect, as in so many others, France was confronted with a very awkward dilemma. Financially she could not afford to continue her political loans to Poland and the countries of the Little Entente. Politically, she could not afford to discontinue them.

(3) Subsidies to Dubious Allies

When Marshal Rydz-Smigly paid a visit to France in 1936, he went home with a new loan contract in his pocket. It is true that the loan consisted not of cash but of armament deliveries, but even so, with French rearmament in full swing the French Treasury could ill afford to pay for the arms of another nation. Czechoslovakia raised a credit from the Bank of International Settlements in 1937. It is understood that the funds were provided by the Bank of France, and the Bank for International Settlements acted only as the intermediary. Roumania and Yugoslavia, too, continued to

receive armament credits from France, even though their political allegiance was becoming highly dubious.

The only country that France ceased to support was Belgium. After the latter's declaration of neutrality, there was no longer any object in supporting her for political ends. For this reason, France claimed the repayment of the loans granted in earlier years, and maturing in 1938. Her place was taken by Great Britain. The fact that the British authorities waived the embargo on foreign loans in favour of a Belgian issue of £5 million at the end of 1937 was due to political considerations. From a British point of view, Belgian neutrality, provided that it was respected, was even more valuable than Belgium's active support. From a French point of view, on the other hand, it meant that the Maginot line had to be prolonged all along the Belgian frontier. At the same time the pro-Italian tendencies of Switzerland's foreign policy necessitated the prolongation of the Maginot line along the Swiss frontier. This, together with the necessity of fortifying the Spanish frontier to some extent as a result of the developments during the civil war, imposed an additional heavy strain upon the resources of the French Treasury.

The decline in France's capacity to finance her allies facilitated the task of Germany and Italy in replacing France to a large extent as suppliers of armaments in Central and South-Eastern Europe. In Chapter XIX we saw how Germany, by becoming the debtor of those countries, managed to induce them to accept armaments in payment of the debt. Even though the countries concerned continued to avail themselves of such French armament credits as they could succeed in obtaining—they would have been foolish not to accept something for nothing—they felt that the star of France's financial power was on the wane. Owing to the gloomy financial outlook of France, it was assumed in Warsaw, Bucharest and Belgrade that she could hardly afford to continue indefinitely to grant them political credits. The increase of the armed strength of Germany coincided with the decline of the financial strength of France, a fact which goes a long way to explain the re-orientation of the foreign policy of various Central and South-Eastern European countries.

(4) New Financial and Political Crisis

Had it been possible to maintain the franc for a long time at the level reached in October 1937, France might have recovered part of her lost political and financial prestige

abroad. As it was, however, the uneasy equilibrium based on the internal political and social truce came to an end towards the middle of January 1938. The immediate cause was the increase of the Government's advances from the Bank of France by 5 milliard francs. The money was needed, it is true, for the repayment of the London credit, and did not therefore constitute new borrowing. Nevertheless, the unfavourable figures of the bank return led to a selling pressure on the franc. This again gave rise to a revival of extremist demand for exchange restrictions. The employers retaliated by refusing to take part in the negotiations arranged by M. Chautemps for the elaboration of a Labour Charter. While at first M. Chautemps sided with the employees, under the inexplicable influence of M. Bonnet he suddenly turned round and adopted the attitude which led to a break in the Popular Front. The Socialist Ministers resigned, which led to the resignation of the whole Cabinet.

In anticipation of this Cabinet crisis, there was a heavy selling pressure on the franc for some days, depleting almost completely the foreign exchange resources of the Exchange Stabilisation Fund. On January 13 it became necessary to allow the franc to find its level. There followed a period of wild fluctuations during which the tendency of the franc was decidedly downward. Its depreciation was not as pronounced as had been anticipated, however, because the effect of the renewed flight of capital was more or less counteracted by bear profit-taking. It became obvious, nevertheless, that owing to lack of foreign exchange resources the French authorities were not in a position to resist any sweeping adverse pressure on the franc.

The second Chautemps Government that emerged from the Cabinet crisis did not command sufficient confidence to inspire repatriation or even to check the outward flow of capital. Attempts to peg the franc at 150 had to be abandoned, and once more the franc had to be allowed to find its own level. Early in March there was another attack on the franc, bringing the rate to the vicinity of 160. The crisis culminated in the resignation of the Chautemps Government, and the franc appeared to be once more in the melting-pot.

(5) Political Effects of new Franc Slump

The weakness of the franc was most unfortunate from an international political point of view. It conveyed the impression that France was on the verge of a breakdown. In reality

this impression was entirely false. Nevertheless, it had a very damaging political effect in that it encouraged the spirit of aggression in Berlin and Rome. It was no coincidence that the Mediterranean situation began to become intolerable during the period of the franc crisis of September and October 1937; that there was a period of comparative calm while the franc remained stable between October and January; and that the menace of German penetration in Central Europe increased owing to the uncertainty of the franc outlook. The view is held that so long as the franc is subject to an acute crisis, France may be ruled out from among the factors in international politics, and the dictators feel that they can afford to steal a march on their opponents. From the point of view of European peace, it is therefore of vital importance that the agony of the franc should not be unnecessarily prolonged. Instead of drawing out its futile defence, the French authorities should accelerate the inevitable downward movement so as to bring the franc to a new equilibrium level as quickly as possible.

(6) Need for Social Equilibrium

Although a drastic devaluation is a preliminary condition of the establishment of stability in France, in itself it is not sufficient. I have emphasised in previous chapters the extent to which France's financial salvation depends upon the adoption of a policy of conciliation and co-operation in internal politics. The future of France and the franc depends largely upon the prospects of social equilibrium. Unless French employers and capitalists can be assured that the Government is not hostile to their interests, there can be no true trade revival in France. Lack of enterprising spirit and of capital would effectively prevent it, even though the rise in prices and activity through rearmament offered good profit possibilities.

The financial problem, too, depends for the most part upon the social problem. If capital could be reassured to a sufficient extent to induce it to return to France on a large scale, this would lead not only to a trade revival but also to a radical improvement in the budgetary position and an increase in the technical strength of the franc at its lower level.

It would be unduly optimistic, however, to expect, for some time at any rate, the return of such a degree of confidence as to solve the financial problem. So long as the parties of the Left have a majority in the Chamber, capital and enterprise are not likely to feel any too safe. The budgetary and

Treasury positions will continue to cause trouble, the franc will remain inherently weak, and this fact in itself would moderate the reflux of capital, even though a moderate improvement of social conditions would encourage the movement to some extent. The maintenance of the franc at its new level would continue to require the utmost effort at a time when France had more important tasks than to concentrate her energies upon the support of the franc.

(7) "FRANCE, PRENDS GARDE!"

It may well be asked whether the game is worth the candle, or whether it would not be a matter of elementary wisdom to take the line of least resistance and allow the franc to decline to a level at which its defence required no abnormal effort or sacrifice. Exactly where that level is, nobody can tell. It has become fashionable to argue that since the devaluation of the franc in 1936, and its further depreciation in 1937, failed to solve the problem, a further drastic reduction would be equally useless. In reality, however, the very fact that at its lower level speculators became hesitant shows that the depreciation was by no means useless. Had a crisis such as that of January 1938 occurred when the franc was at 75, or even at 105, we should have witnessed a sweeping fluctuation leading to a spectacular depreciation. With the franc in the vicinity of 150, speculators were, if anything, supporting it. A further depreciation to, say, 200 or 250 would increase such speculative support to a sufficient extent to render the franc much less vulnerable.

In addition to a drastic depreciation of the franc, it will be necessary, sooner or later, to scale down the public debt charges through a wholesale forced conversion on the lines suggested by M. Henri Michel in his book *France, Prends Garde!* Admittedly, both a drastic devaluation and a forced conversion would be extreme measures and most politicians would be unwilling to assume responsibility for them. What is needed is a Government of National Union, based on the largest possible number of parties, which would thus share in the responsibility for the unpopular measure. A Finance Minister with the ability, courage and imagination of M. Paul Reynaud, supported by such a coalition, would be able to tackle the problem and find a way out of the present deadlock.

CHAPTER XLI

HITLER DROPS THE PILOT

(1) A Gradual Eclipse

One would imagine that since Dr. Schacht, through his efficient execution of the National Socialist economic policy, had placed the National Socialist Government under an immense obligation, his position would have become unassailable. There is, however, no such thing as gratitude in politics. As German rearmament progressed, Dr. Schacht's position became increasingly precarious. By 1937 he was no longer considered indispensable. The system which he had established was working as a matter of routine. For this reason his enemies in the National Socialist party began to undermine his position. During the late summer and autumn of 1937 they succeeded in achieving this end.

Dr. Schacht's eclipse produced no immediate visible effect on the German economic and financial situation. This was largely due to the fact that his eclipse was gradual. Until the beginning of 1936 he was unquestionably the all-powerful economic dictator of Germany. In fact, the impression was beginning to gain ground that for all practical purposes Dr. Schacht was the real power behind the scenes, and that Hitler himself was merely the political façade, in the same way that, in Portugal, General Carmona is the political façade for the highly efficient dictatorship of Professor Salazar. This theory, like others according to which Goering, or even Goebbels, was the real dictator, was entirely without foundation. Dr. Schacht, like all other prominent politicians in the Nazi régime, derived his power entirely from Hitler, and was liable to be removed whenever Hitler wished.

From the very outset it should have been evident that Dr. Schacht's power was purely temporary. He was not a Fascist, but an orthodox banker. He was prepared to serve the régime, because he felt that in doing so he was serving Germany. He never went out of his way to strengthen his position by making friends with " the right people ". On the contrary, being an uncompromising character, he made many powerful enemies.

For one thing, he never joined the National Socialist party, preferring his incredibly high stiff collar to the brown shirt. Hitler was prepared to put up with this non-Nazi expert because of his expert knowledge and the confidence which his name commanded. It was obvious that the moment he thought he could dispense with Dr. Schacht's services he would drop him without the least hesitation.

(2) Fighting a Losing Battle

During the greater part of 1936 and throughout 1937 Dr. Schacht's influence was gradually declining. The "mistake" which led to his downfall was his opposition to the continuation of rearmament expenditure on a gigantic scale. By 1937 the German armed forces had more than made up for lost time, and there was no longer any necessity for abnormal expenditure beyond keeping up the strength which had been acquired. Nevertheless, the appetite of the High Command was insatiable, and when Dr. Schacht objected to the additional milliards he lost the support of the Reichswehr. From that moment it was obvious that his power was on the wane. Even while he remained nominally at the head of the Ministry of National Economy, he had ceased to have the actual power, and German economic policy came more and more under General Goering's control.

Dr. Schacht was well aware that he was fighting a losing battle, but this did not in any way damp his fighting spirit. Nor did he conceal his contempt for various Nazi institutions. The story goes that on one occasion he was invited as the guest of honour to a meeting held by the "Strength through Joy" organisation, one of the objects of which is to provide holiday trips abroad for workers. The Chairman introduced Dr. Schacht to the assembly as the man who was going to provide the exchange for that purpose. When Dr. Schacht's turn came to speak, he said: "If you think I am going to provide you with exchange, the sooner you disabuse your minds of such thoughts the better. There is no exchange available, even for much more important requirements. In fact, let me tell you that if the exchange position were such that I could afford to let you have exchange, I should no longer be left at my post."

In scathing sarcasm he is second to none in the present generation, and he was seldom able to resist the temptation to exercise this quality at the expense of his fellow Cabinet

Ministers and other prominent party leaders. There was no lack of lively scenes in the course of Cabinet councils and other conferences in which both he and General Goering took part. On one occasion, when General Goering was advocating an over-ambitious scheme, Dr. Schacht is reported to have inquired: "*Warum diese Judeneile?*" ("Why this Jewish haste?"), a remark which, in view of the feelings prevailing in Nazi breasts towards their non-Aryan fellow-men, amounted to the gravest possible insult. This and other similar gibes hastened Dr. Schacht's doom, but he thoroughly enjoyed the game while it lasted.

(3) Resignation Denied—then Accepted

By the late summer of 1937, rumours of his impending resignation from the Ministry of National Economy were becoming more and more definite. Possibly the Government wanted to prepare the public for the impending change. For a time the resignation was officially denied, but when it was found that the rumours did not themselves produce any spectacular effects, and when Dr. Schacht himself admitted to the Press that he was no longer Minister of National Economy, this fact had to be officially recognised. He nominally retained the Presidency of the Reichsbank, although even there he was hardly more than a figure-head. Nevertheless, the fact that he did not sever his connection with the Government—in fact, when his resignation from the Ministry of National Economy was admitted, Hitler made him a Minister without portfolio—helped to minimise the effect of his eclipse upon German public opinion. Had he been summarily dismissed from his posts, and thrown into a concentration camp, as many of his opponents wished, the shock to German public opinion would undoubtedly have produced a spectacular effect. Hitler was, however, well advised to abstain from giving full satisfaction to Dr. Schacht's enemies at the risk of jeopardising Germany's economic and financial stability.

(4) Mr. Montagu Norman's Support

Mr. Montagu Norman, whose friendship with Dr. Schacht has played such an important part in the shaping of the Bank of England's policy throughout the post-war period, made an eleventh-hour attempt to strengthen his friend's position by securing for him a diplomatic victory at Basle. The opportunity was provided by the deeply deplored death, through a

bathing accident, of the French General Manager of the Bank for International Settlements, M. Pierre Quesnay, in September 1937. From the very outset it was taken for granted by most people that the post would be filled by another Frenchman, and the only question was, who among the leading experts would be chosen by the Bank of France. The fact that the Bank of France and the French Government were by far the largest depositors was the foundation of the French claim upon the General Managership. Mr. Norman, however, had other ideas on the subject. When the Board of the Bank met on October 11, he and Sir Otto Niemeyer opposed the French claim by putting forward the principle that the vacancy should be filled by the most suitable man, irrespective of his nationality. In plain English this meant that they sponsored the appointment of Herr Hechler, the Assistant General Manager, who after M. Quesnay's death became acting General Manager. Although there can be no doubt of Herr Hechler's ability, his experience with the Bank for International Settlements had been comparatively brief, and he certainly did not possess the main qualification for the General Manager's post, namely an international mind. Indeed, under the present régime any German who was sufficiently internationally minded to qualify for the post would long ago have been sent to a concentration camp. Nor could Herr Hechler be compared in ability with most of the possible French candidates.

In the circumstances the claim put forward by Mr. Norman and Sir Otto Niemeyer can only be explained on the ground of their desire to allocate the post to a German. When their attitude in this matter became known, it caused general astonishment, since it appeared to be in conflict with the official foreign policy of Downing Street, based on the London-Paris axis. This was not the first time that Mr. Norman had pursued a foreign policy of his own, but never had the conflict between his foreign policy and that of the Government been so obvious as on the present occasion. In all probability Mr. Norman hoped that by securing the General Managership for a German he would assist in strengthening Dr. Schacht's position. It ought to have been obvious by October that nothing could possibly save Dr. Schacht from losing his position. Notwithstanding this, Mr. Norman persisted in his attitude also at the Board meeting in November, and in face of the conflicting views between him and the French Directors it was impossible to reach any decision.

At the December meeting Mr. Norman was persuaded to agree to the appointment of M. Aubouin, who was particularly qualified to fill the post. Mr. Norman was thus unable to secure a diplomatic victory for Dr. Schacht, but even if he had, it would have made but little difference to the latter's position. By then it was generally understood that although he had nominally retained the Presidency of the Reichsbank, he would cease to possess any actual power.

Nevertheless, those who know Dr. Schacht are convinced that he is not finished by a long way. On the previous occasion, in 1930, when he chose to relinquish his power rather than endorse a policy of which he disapproved, his eclipse was generally believed to be temporary, and his return was regarded as a mere matter of time. On the present occasion, too, he remains an important potential factor in the German situation. His rehabilitation would be all the easier this time because technically he still remains the President of the Reichsbank. In fact, although his term of office should have expired on March 31, 1938, it has been renewed for another four years. There can be no doubt, however, that, for the time being at any rate, Field-Marshal Goering has gained the upper hand.

(5) German Efforts to raise New Credits

The change from the Schacht régime to the Goering régime produced no immediate effect upon the German economic and financial situation. The fears entertained by many of Germany's foreign creditors that, with Dr. Schacht's departure, they would receive even less favourable terms than before, have not, up to the time of writing, been realised. In fact, in the course of the Standstill negotiations held in London in December, the Germans agreed to the repayment of 10 per cent of the credits guaranteed by the Gold Discount Bank. It is true that the amount involved was only about £750,000, but the gesture was nevertheless reassuring. Moreover, the German debtors promised to make an effort to replace as far as possible the frozen financial bills by genuine commercial bills.

The reason for this minor concession was the desire to secure new credits outside the Standstill Agreement. Several London banking houses are, in fact, known to have granted such new credits. In some instances they had security outside Germany, and in others they were prepared to accept the promise of the Reichsbank that the sterling would be forthcoming on maturity. The German authorities naturally endeavoured to increase the

amount of such new credits. What could not so easily be understood was that London bankers should lend themselves to the game. It was detrimental to the Standstill creditors, since the genuine bills which were drawn on new credits were replaced in the Standstill by frozen finance bills. Even from a purely selfish point of view it was risky to grant credits to Germany. Earlier in 1937 efforts to that end had been frustrated by the attitude of part of the Press and the House of Commons. Although questions to the Chancellor about new credits to Germany were, as usual, given evasive answers, the result was nevertheless that the Government, through the Bank of England, expressed its disapproval of the granting of new credits. This vague and hesitating intervention was, however, forgotten by the autumn.

(6) Guns *v.* Butter

Admittedly the credits granted outside the Standstill Agreement were moderate. A small but influential section of British opinion was, however, in favour of granting credits to Germany on a large scale, if necessary under official guarantee. The view that the peace of Europe could only be safeguarded by the granting of credits to Germany was shared by Mr. George Lansbury, who, having discovered in 1937 that there was some kind of economic depression, grew very excited, and set out to tour the European capitals to ascertain what could be done about it. Everybody, including Hitler and Mussolini, was so nice to him that he returned firmly convinced that the whole world, with the exception of the British National Government, wanted peace, and that all problems making for war could be solved by granting credits to Germany and Italy.

Those who held similar views were inclined to assume that the aggressive attitude of Germany was solely due to her lack of foreign exchange resources; the fact that Goering's declared "guns rather than butter" policy was responsible for the food shortage was entirely overlooked by those who maintained that if only Germany could be given adequate resources, whether through the restoration of her colonies or through the granting of large credits, she would cease to be a danger to peace. At any moment the food shortage could be brought to an end by calling a halt in the feverish rearmament programme pursued ever since 1933. There would then be plenty of butter, even without the restoration of the colonies and the granting of credits. As a matter of fact, once Germany called a halt in

rearmament and adopted a conciliatory foreign policy, there would be no lack of new credits. This would not, however, suit the book of the National Socialist régime, which would not be able to enjoy the butter unless it had been obtained as a result of a victory, even if it were only a diplomatic one. Goering, to judge by appearances, does not altogether despise butter. He wants to have it, not as an alternative to guns, but as a result of first having acquired all the guns he needs in order to intimidate those nations which prefer butter to guns.

(7) The Case against granting Credits to Germany

There is no reason whatsoever to suppose that German foreign policy would change for the better as a result of colonial concessions or the granting of credits. The chances are that once Germany was able to increase further her raw-material imports for rearmament requirements, and to accumulate a food reserve, she would become more aggressive than ever. As *Pertinax* rightly pointed out in an article appearing in the *Echo de Paris* in January 1938, the reason why there was no major European war during 1937 was that there was economic and financial stringency in the two aggressive States. This view is based upon a remark which General Fritsch, late Commander-in-Chief of the Reichswehr, is said to have made when opposing the sending of several divisions to Spain: "One may have to put up with bread tickets at the end of a war, but one cannot *start* a war with bread tickets." Indeed, in case of a major war, conditions of food supply in Germany would from the very beginning be as bad as they were towards the end of the last war. While Germany's General Staff entertains hopes that the next war would last only a few weeks, or a few months at most, it does not wish to stake everything on that hope, which is far from having been confirmed by experience in Spain and China. The Reichswehr is not likely to declare itself ready to deliver the blow until Germany has accumulated an adequate supply of food and the essential raw materials, or, alternatively, has become self-supporting in those commodities. The main idea of Goering's Four Year Plan is to attain this degree of self-sufficiency.

This being so, it would be little short of suicidal to assist Germany in the task of accumulating the necessary reserve. Sooner or later she will be in possession of the necessary goods or the means for their production. There is no reason, however, why her efforts to that end should be assisted by the prospective victims of her aggression. After all, the time

factor is in favour of those nations which were late in entering the rearmament race.

The controversy between those who were in favour of granting Germany credits and those who opposed it was very obligingly solved by no less a person than Hitler himself. In his Reichstag speech, on the fifth anniversary of the inauguration of the Nazi régime, he declared in unequivocal terms that Germany would not think of accepting foreign credits as an alternative to colonial concessions, or, indeed, as part of any kind of political bargain. Strangely enough, even after this statement there were still people in Great Britain who were in favour of offering credits to Germany in addition to making her colonial concessions and without the slightest hope of obtaining in turn at least a promise of the limitation of armaments.

Hitler's speech, which literally bristled with figures showing the progress achieved during the five years of the Nazi régime, but which carefully avoided giving facts and figures about the other side of the picture, was also significant from the financial point of view, for its emphatic rejection of the idea of a devaluation of the reichsmark. A few days later, however, the new Minister of National Economy, Herr Walter Funck, made some cryptic remarks about the eventual adjustment of the reichsmark, after the settlement of the question of Germany's external debt. His idea about that settlement was that, since it was humiliating for Germany to see her external loans quoted so much below par, the best solution would be to cut down the capital value of the loans to the vicinity of their market quotations. Considering that the decline in the market quotations was entirely the result of the almost complete default on the external debt service, the scheme is open to grave objections from the point of view of commercial morality. Nevertheless, it is to be feared that sooner or later the creditors will have to accept some such solution.

PART X

CONCLUSION

CHAPTER XLII

STABILISATION PROSPECTS

(1) Hopes Raised by Tripartite Agreement

Ever since the suspension of the gold standard in Great Britain in 1931, there has been a strong current of opinion in favour of re-stabilisation. This movement reached its climax during 1935, when France and the other members of the Gold Bloc did their utmost to persuade Great Britain and the United States to stabilise their currencies. With the conclusion of the Tripartite Agreement a compromise was reached by which the three leading countries agreed that, while reserving their right to yield to a sweeping pressure, they would not deliberately depreciate their currencies in order to secure commercial advantages. In September 1936 the world seemed to enter a period of pre-stabilisation.

This progress towards the goal of definite stabilisation was welcomed with enthusiasm in the stabilisationist camp, where it was believed that before very long the vague and informal arrangement of the Tripartite Agreement would be replaced by a definite agreement linking the various currencies to gold. Before many months had passed it was evident that their optimism had been premature. The franc proved to be untenable at its new level, and the Blum-Auriol Government had to decide in March 1937 to allow it to depreciate to the vicinity of its lower legal limit.

(2) France not Ready for Stabilisation

By that time it was amply evident that France was by no means ready for stabilisation. Her budget was hopelessly unbalanced and her public debt was increasing at an alarming pace. Nor did her internal price level reach equilibrium. It continued to be affected by the gradual application of the 40-hour week. The deficit of French visible trade increased considerably in spite of the devaluation of the franc. Internal political conditions were anything but stable, and the international political tension was becoming increasingly menacing. In such circumstances, no French statesman would have dared

to link the franc definitely to gold. As for the economists, the same people who until a year before had urged international stabilisation were now urging the restoration of the freedom of the franc, even at the risk of jeopardising the Tripartite Agreement. We saw in Chapter XI that MM. Baudouin and Rist resigned from the expert committee in charge of the management of the Exchange Stabilisation Fund because the Blum Government was not prepared to follow their advice concerning a higher degree of elasticity for the franc.

The subsequent slump of the franc during the summer and early autumn of the year proved how right were those who were against its legal stabilisation. There is not the slightest reason to suppose that, if France and the other leading countries had agreed upon the restoration of the gold standard, this would have obviated the sweeping attacks on the franc that compelled the Chautemps-Bonnet Government to allow it to find its level. The cause of these attacks was not primarily the fear of depreciation, but the general social, industrial and economic conditions, combined with the hopeless budgetary position. In this respect, the restoration of the gold standard would have made no difference.

(3) Gold Scare and Stabilisationist Movement

The gold scare resulted in a temporary revival of the demand for stabilisation, especially in the gold-producing countries. South Africa in particular was very anxious that fears about a cut in the price of gold should be allayed by legal stabilisation. In fact, the Government of the Union is said to have been quite prepared to agree to a minor cut in the price if it were accompanied by the restoration of the gold standard. Proposals to that effect are said to have been discussed during the Imperial Conference in London in June 1937. The anxiety of a country whose prosperity is based entirely on gold production can easily be understood, although the Union Government, in taking the gold scare rumours so seriously, displayed remarkable short-sightedness. Fortunately for South Africa and other gold-producing countries, neither Great Britain nor the United States, still less France, was ready to stabilise at that time. Otherwise some solution on the lines suggested by the South African Government might conceivably have been adopted. In the meantime it has become clear that there is not the least likelihood of a cut in the price of gold, and that the chances are that in the long run the price will even rise. With the termination of the gold scare, the re-

newed agitation in favour of an immediate stabilisation also subsided.

The British attitude towards stabilisation is largely influenced by the fear that it would be accompanied by a rise in interest rates. The Government is well aware that in order to be able to finance its rearmament scheme it will have to avoid anything that might lead to higher money rates. There can be little doubt that, in case of the restoration of the gold standard, a situation might soon arise in which the authorities would be compelled to raise the bank rate, thereby increasing the cost of rearmament financing, and, what is much more important, drying up the available resources which are required for the purpose.

(4) Effect of Trade Setback

Since the beginning of the autumn, such hopes and fears of an early stabilisation as may have lingered until then have vanished completely, partly as a result of the trade recession and partly in consequence of the distinct aggravation of the international political outlook. The United States Government excluded the word " stabilisation " from its vocabulary, for the time being. While there is no evidence that it actually considered the idea of the devaluation of the dollar, it certainly had not the least intention of burning its boats by linking the dollar definitely to gold. Similarly, the fear of a major trade setback ruled out the possibility—if it had ever existed—of an early stabilisation by Great Britain.

At the same time, with the Mediterranean tension on the one hand and the Far Eastern conflict on the other, the British, French and United States Governments would not have cared to commit themselves to legal stabilisation. It was evident that a war, or even a major war scare, would wreck a newly-established gold standard, and no Government wished to expose itself to that.

Even in the absence of such grave political developments, most people are now not nearly so certain that the present level of the currencies is the definite one as they were even a year ago. The outlook of the franc is most uncertain, and its further sharp depreciation might lead to an all-round depreciation or devaluation of other currencies. The necessity for lowering the burden of public debts is beginning to be realised to an increasing degree, and while opinion is divided as to whether this should be done through forced conversion or drastic devaluation, the chances are that both methods will

be resorted to in many countries. Nobody knows to what extent the burden of the public debt will have to be increased as a result of the reckless rearmament race, which, as far as can be seen at present, can only continue at an increasing pace. This being so, few Governments would care to commit themselves definitely against another devaluation. Needless to say, even the restoration of the gold standard would not preclude that step, but it would increase the difficulties attached to it to no slight extent.

(5) The "New Gold Standard"

One of the main reasons why there is much less talk about stabilisation than there was a year or two ago is that the prevailing conception regarding the nature of the gold standard has changed. A large section of expert and public opinion has adopted the view that there can be no question of ever returning to the gold standard as it operated before 1931. The belief that for all practical purposes we are now on the gold standard is becoming increasingly popular.

There is a great deal to be said in support of the conception which regards as the criterion of the gold standard, not the convertibility of notes at a fixed parity, nor the freedom of private arbitrage, but the maintenance of a relative stability with the aid of international gold movements. As a result of Exchange Equalisation Account operations, every surplus or deficit in the trade balance, and every capital movement, tends to bring about a corresponding change in the gold reserves of the countries concerned, in the same way as under the gold standard. The only difference is that this change is no longer brought about by private arbitrage, but for the most part by official gold earmarking and unearmarking operations. It is true that the exchange rates are allowed to fluctuate within wider limits than under the gold standard in the old sense of the term. In this respect the new gold standard is distinctly more elastic than the old one was. On the other hand, from time to time under the new gold standard the exchange rates are maintained more rigidly than under the old system. While the spread between gold import point and export point was usually between $\frac{3}{4}$ and 1 per cent, very often Exchange Equalisation Account operations maintain the range of fluctations at 1–16 per cent or less. On such occasions the Exchange Equalisation Accounts often operate in both directions on the same day, so that within a few hours a country may lose gold and regain it through

minor fluctuations of its exchange—an occurrence which was extremely rare under the gold standard.

It is possible, and even probable, that the monetary system will not materially depart from its new basic principles. Although during the gold scare there was much agitation in favour of resuming free coinage in order to unload unwanted gold upon the public, there is no reason to suppose that many countries will follow this suggestion. The free convertibility of notes into gold may be regarded as a matter of the past. Nor are most Governments likely to relinquish their right to change the parities, if necessary, by administrative action.

Although this system may not satisfy orthodox purists, it is certainly workable, and in many ways has more advantages than the old system of the gold standard. The more it is realised that this system is the new gold standard, the less talk will there be about stabilisation, whether in the near future or in the more distant future.

(6) The van Zeeland Report

For the reasons enumerated above, M. van Zeeland's proposal for the restoration of international monetary stability, together with most of his other proposals, is likely to remain dead letter for a long time. There are so many conditions which would have to be fulfilled in order to permit the return of legal monetary stability that it would require an unwarranted degree of optimism to hope for an early decision to that effect. The primitive idea that monetary stability could be established simply by declaring the currencies to be stable is gradually being discredited. Most people realise now that monetary policy is not omnipotent, but is subject to the working of powerful factors, political and economic. It is largely because political and economic factors are so closely interwoven that most of M. van Zeeland's recommendations, wise as they may be in theory, are likely to prove inapplicable in practice. M. van Zeeland must realise the extent to which the adoption of his programme depends on guarantees of a political nature. Obviously there can be no removal of exchange restrictions without a strengthening of the foreign exchange reserves of financially weak countries. Such assistance is, however, out of the question unless the "Have Not" countries are prepared to provide guarantees of a political nature. They do not appear to be willing to provide such guarantees at the present stage, and even if they did it is doubtful whether the mere signing of an agreement would be

sufficient to induce the democratic countries to part with the cash. The solution will have to be found in the political field. Nothing short of the adoption of a genuine conciliatory policy by the aggressive nations could remove the obstacles to international lending and thereby re-open channels of international trade and transfers, leading to definite monetary stabilisation.

CHAPTER XLIII

THE NEXT TWELVE MONTHS

(1) The Unknown Political Factor

The past twelve months have witnessed some spectacular changes from one extreme to the other in more than one direction. We have experienced a gold scare and, a few months later, a gold rush. The boom during the first quarter of 1937 was followed by a slump during the last quarter. The flight to the dollar gave way to a flight from the dollar. The rise in commodity prices and stock prices was followed by a sharp setback. Even the flight from the franc became reversed for a time.

No human being could possibly have foreseen all these changes, and in such circumstances it is easy to understand that, when attempting to make a forecast of the developments during the next twelve months, I have to do so with the utmost trepidation and subject to many reservations. First of all, there is the unknown political factor. For the sake of argument, we have to assume that there will be no world war or European war, even though the wars in Spain and China may continue throughout the period concerned. Unfortunately, even this assumption requires a high degree of optimism. Nobody is in a position to foretell how long world peace can be preserved. We all hope that the civilised world will not commit suicide by embarking upon another mass murder much worse than that experienced between 1914 and 1918. But while we hope for the best we cannot overlook the possibility of the worst, which might occur at almost any time. Europe had some narrow escapes during 1937, and it is doubtful whether we are justified in assuming that we shall continue to be as lucky during the coming twelve months. Nevertheless, we have to carry on as usual, even under the shadow of the threat of a destructive war. It is necessary to assume, for the sake of argument at any rate, that, apart from Spain and China, the world will continue to enjoy peace during the year 1938–39.

(2) Rearmament to Continue

It is reasonable to take it for granted that preparations for the next war will continue on a gigantic scale. Such chances as existed a year ago that there might be an agreement for disarmament, or at least for a limitation of armaments, have completely disappeared. The international rearmament race will continue, and in all probability will assume increasing dimensions. The leading participants in the rearmament race are likely to intensify their efforts rather than slacken them. Their number has already been increased by the addition of the United States, which, at the time of writing, is on the verge of throwing itself whole-heartedly into the rearmament race. The change of régime in Brazil was followed, for no apparent reason, by the adoption of a policy of increasing that country's armed strength, and it is safe to assume that other South American countries will follow her example.

Whatever view we may take about the political aspects of this rearmament race, from a purely economic point of view it will certainly produce a beneficial effect. The chances are that it will check, and even reverse, the trade setback which, in the absence of the rearmament race, would inevitably have developed into a major slump and a prolonged depression. It is true that the bill will have to be paid sooner or later, but in this chapter we are concerned only with the next twelve months, and from this narrow point of view there is no cause for immediate worry about the budgetary consequences of rearmament in most countries. It is also true that much valuable and irreplaceable raw material is used up for the manufacture of arms, and that a large part of the valuable assets of mankind thus ceases to be available for constructive purposes. This, however, is not a problem which concerns the next twelve months. Possibly a future generation will curse our lack of foresight in using up valuable metals, whose supply may by then have become exhausted. For the moment, however, this stage has not been reached in any of the metals or materials used for rearmament purposes. The existence of a danger that the civilised world might be destroyed by a world war justifies, perhaps, the spirit of "*après moi, la déluge*" in which the prosperity created by the rearmament race is enjoyed.

The same reason which makes the advent of a trade recovery probable within the next twelve months also justifies the assumption that the prices of commodities and Stock Exchange

securities are likely to rise. Accordingly, the rise in the cost of living will be resumed.

(3) Budgets and Public Debts

It may be taken for granted that budgets will remain hopelessly unbalanced during the coming year. In fact, the extent of budgetary deficits will in all probability increase. Even in countries such as the United States, where politicians and economists have until recently paid lip-service to the necessity of balancing the budget, the idea has been dropped as a result of the decision to rearm. In Great Britain the pace of rearmament is expected to reach its peak during the next fiscal year, and for this reason the deficit is expected to increase materially. In France, too, the deficit due to expenditure on national defence will be increased; the revival of competition with Italy in naval armament, and with Germany in the strengthening of the Air Force, provides the main cause for both countries to spend additional milliards. Like most other Governments whose budget is already hopelessly unbalanced, the French and Italian Governments adopt the attitude that they may as well be hanged for a sheep as for a lamb.

The budgetary deficit through rearmament entails an increase of the public debt. Each country will endeavour to consolidate as much as possible of the additional debt, but in some instances, at any rate, the difficulty of placing additional bonds will necessitate the increase of the floating debt, and even crude inflationary borrowing from the Central Bank. In some instances this inflationary borrowing is bound to undermine the technical strength of the currency to such an extent as to make its further depreciation inevitable.

(4) Foreign Exchange Prospects

As far as the franc is concerned, such a depreciation in the course of the next twelve months may be considered certain, although opinions may differ widely as to its probable extent. Whether or not any attempt is made to check the depreciation by means of exchange restrictions depends upon internal political developments, the course of which it is impossible to foresee. It is just conceivable that the establishment of a Government of National Union might arrest the downward trend of the franc, but the very uncertainty of the existence of that Government in the present composition of the Chamber may prevent it from inspiring a sufficient degree of confidence to lead to wholesale repatriation. It is conceivable that the

French authorities may adopt the tactics practised by M. Poincaré in allowing the franc to depreciate to a very considerable extent and then causing it to appreciate, thereby squeezing bear speculators and encouraging repatriation. On the whole, it seems more probable that the franc will be allowed to depreciate gradually and that most of the advantages derived from its depreciation will thus be wasted.

It seems probable that the sterling–dollar rate will be kept in the vicinity of 5.00, with a range of fluctuations of about 2 or 3 per cent. This rate has come to be regarded as representing more or less the new sterling–dollar parity, and official British quarters, which two years ago felt very strongly about the necessity for lowering that rate, are now inclined to await developments. Although at the moment the dollar is probably undervalued in relation to sterling, it is possible that, as a result of rearmament in the United States and of the progress of the labour movement, equilibrium may be restored. The probable conclusion of an Anglo-American trade agreement would in itself be sufficient to rule out the possibility of any drastic change in the sterling–dollar rate, for the terms of that agreement will have to be based on some definite exchange rate. Co-operation between London and Washington is close, and should be able to prevent or minimise unwanted exchange movements.

Quite conceivably sterling may be subject to adverse pressure through international political developments, or the dollar may be subject to adverse pressure through the withdrawal of "hot money" or industrial troubles. Neither of these tendencies is, however, likely to get out of control. A revival of trade through rearmament in the United States would obviate the recurrence of the dollar scare, and might possibly lead to an influx of foreign funds to take advantage of the recovery in Wall Street.

Among the other exchanges, it is possible that the lira or the belga may be affected by a further depreciation of the franc, in which case we may witness another all-round depreciation of the continental exchanges. The chances are, however, on the whole, against this taking place in the course of the next twelve months.

(5) Gold Prospects

If the trade recovery and the rise in commodity and security prices should develop into a boom—although this stage is not likely to be reached within the next twelve months—we might

then witness a revival of the gold scare. At the time of writing, with re-hoarding of gold in full swing, this suggestion may sound as absurd as the forecast of this re-hoarding would have sounded during the gold scare of 1937. Admittedly, the same set of circumstances which brought about last year's gold scare is not likely to recur, but a similar result might easily be produced by a different set of circumstances. Some of the factors, at any rate, might recur. The figures of gold production and of gold stocks will continue to show an increase, even though in the case of Soviet Russia a setback may reasonably be anticipated. A boom-like rise in security and commodity prices might conceivably lead to the anticipation that the United States might cut its buying price of gold in order to check the movement. It should be borne in mind, however, that President Roosevelt must have learnt his lesson last year, and must realise by now that an unwanted rise in commodity prices is a distinctly lesser evil than an unwanted fall. Nevertheless, the very fact of the recurrence of a boom would result in rumours of a possible cut in the price of gold. Since in the meantime the volume of hoarded gold is likely to have risen once more to a considerable figure, we may even witness another spell of panicky dishoarding. It is equally conceivable that a fresh increase in the volume of European refugee money in the United States might lead to talk about the possible limitation of American gold purchases. There is no reason to suppose, however, that the next gold scare would assume the same dimensions as that of 1937. On the basis of last year's experience, the United States would no doubt do its utmost to allay fears in good time, before the gold scare had a chance to gather sweeping force.

Interest rates are likely to remain low, even if the revival of trade should lead to an increase of demand for credit. The authorities in the leading countries will do their utmost to maintain cheap money, partly in order to avoid a relapse similar to that of the autumn of 1937 and partly in order to facilitate the financing of rearmament. Possibly long-term interest rates may rise as a result of trade recovery and borrowing for rearmament, but even in this respect the authorities will do their utmost to keep down the increase.

(6) Foreign Trade and Transfers

Rearmament is likely to continue to affect adversely the trade balance of the countries involved, though if the movement becomes really world-wide the tendency is bound to

become less one-sided. After all, all countries cannot have adverse trade balances—unless they devise some method of importing from the moon or from Mars. Much will, of course, depend upon the degree of rearmament. There is no likelihood of the Latin-American States, for instance, embarking upon rearmament on a scale comparable with that of the European countries.

Notwithstanding the van Zeeland report, hopes of a removal of restrictions on international trade and international transfers are not likely to materialise to any substantial extent during the next twelve months. In fact, the outlook in this respect is less favourable than it was twelve months ago, when the conclusion of the Tripartite Agreement gave rise to hopes of a gradual freeing of exchanges and lowering of trade barriers. Possibly countries such as France might adopt exchange restrictions, and circumstances might force Japan, and even Great Britain and the United States, to conclude a number of exchange clearing agreements.

Official intervention in the foreign exchange market, the gold market and other sections of the international financial apparatus is likely to be maintained, if not extended, in the course of the next twelve months. Although sooner or later the pendulum is likely to swing back, that stage is not likely to be reached in the near future. The international political tension and the requirements of rearmament are themselves sufficient to make for more official control and intervention.

On the whole, it seems probable that economic and financial conditions in twelve months' time will show much similarity to the conditions prevailing prior to the setback caused by the gold scare of 1937. The "Rich Men's Revolt", which was such a prominent feature of the past year, is likely to be placated in most countries by the provision of additional profit possibilities as a result of rearmament. The trade recovery will enable employers to meet Labour's demands to a very large degree without thereby sacrificing their prospects of profit.

CHAPTER XLIV

FUTURE OUTLOOK

(1) Basic Factors

Having considered the economic and financial prospects for the next twelve months, we must next cast a glance towards the more distant prospects. Paradoxical as it may sound, it is easier to forecast the trend of economic and financial developments within, say, the next ten years than within the next twelve months. There are certain fundamental factors which in the long run are bound to determine the trend, but their effect may be offset by cross-currents in the short run. It was comparatively easy to foretell in 1932 that the world would witness a reversal of the downward trend of prices, but whether the change would take place within the next twelve months or several years later it was almost impossible to foresee. Similarly, at the present stage it is easy to foresee that in the long run commodity prices will rise to a much higher level than the peak touched in 1937, but it would be very risky to prophesy whether the rise will take place this year, next year or the year after.

In examining the more distant prospects, our task is to ascertain the basic factors which are likely to operate in the long run, and the possible secondary currents which are likely either to hamper or to stimulate the operation of these factors. The following are the most important among the basic factors which in the course of the next decade or two are likely to determine the underlying trend:

(1) The change in the gold value of the currencies.
(2) The increase of gold production.
(3) The excessive burden of public indebtedness.
(4) The rearmament race.
(5) The expansionary tendency of monetary policy.
(6) The likelihood of further currency depreciations in terms of gold.

(2) Devaluations and the Price Level

Although it would be idle to attempt to establish a rigid relationship between the gold value of currencies and the level

of prices, there can be no doubt that there is a strong tendency towards adjustment of the latter to any major changes in the former. One of the reasons why the price level declined to the vicinity of the pre-war level during the depression was that the gold value of the leading currencies was restored to its pre-war level. Admittedly, it took a number of years for the process of adjustment to be completed. Nevertheless, there can be no doubt about the existence of the trend. Now that the major currencies have been devalued by more than 40 per cent, there should be in operation a fundamental tendency towards the adjustment of the price level to this change. A devaluation by about 40 per cent would justify a rise in the price level by approximately 70 per cent. This does not necessarily mean that in the long run the rise will be exactly, or even approximately, that percentage above the pre-devaluation level. There can be no doubt, however, that the present level is much too low on the basis of the changed gold value of the currencies.

The process of the adjustment of the price level to the changed gold value of the currencies will be facilitated and accentuated by the spectacular increase in the volume of current gold production. Here again it would be idle to try to establish a definite arithmetic ratio between the volume of the world's monetary gold stock and the level of prices, but there can be no doubt that the former constitutes in the long run one of the most important, if not the most important, factors affecting the trend of prices. The scarcity of gold before 1931 was largely responsible for the collapse of the price level. The existence of a huge surplus of gold in excess of immediate requirements will undoubtedly tend to influence the price level in an upward direction during the coming years.

(3) The Burden of Indebtedness

The existence in most countries of a huge public debt, the service of which absorbs a disproportionately large part of the national income, is yet another factor making for higher prices. The relation between the level of indebtedness, public or private, and the level of prices is even less obvious than that between the gold value of currencies or the volume of monetary gold on the one hand and the level of prices on the other. Nevertheless, it stands to reason that fictitious wealth in the form of public or private debt cannot rise indefinitely without reacting upon the price level. When the burden becomes unbearable, it leads to a depreciation in the currencies as a

result of a currency crisis, as in Great Britain, a banking crisis, as in the United States, or a Treasury crisis, as in France.

Admittedly, a rise in commodity prices is not the only way in which the burden of indebtedness can be reduced. There is the alternative remedy of repudiation, or at least forced conversion. This alternative remedy was resorted to in various instances, the most characteristic of which was the decision of the United States to repudiate the gold clause in loan contracts. No doubt the remedy of forced conversion will be resorted to by a number of countries in the course of the next ten years. There is already a certain amount of agitation in its favour in both France and Germany. It is doubtful, however, whether any Government will be able to go very far in that direction without inflicting grievous harm upon investors, insurance companies, banks and, last but by no means least, upon its own credit. The reduction of the burden of indebtedness by means of a monetary policy aiming at a rise in prices, or by means of a rise in prices which takes place even in the absence of a deliberate policy to that end, is far less painful. It is less damaging to the credit of the Government than outright repudiation or forced conversion. This fact was amply proved by the British experience of 1932, when only a few months after the suspension of the gold standard and the depreciation of sterling the Government was able to carry out the gigantic conversion of War Loan from a 5 per cent to a 3½ per cent basis. In extreme cases the excessive burden of indebtedness automatically brings about a depreciation of the currency and a rise in commodity prices. This is what is taking place in France, where, owing to the excessive burden of indebtedness, the budgetary problem is impossible to solve, and where the difficulty of placing additional loans with the public compels the Government to meet the Treasury's requirements by means of inflationary borrowing, leading to a depreciation of the franc. Although other countries have not yet reached that stage, some of them at any rate are not very far from it and may yet reach it as a result of the further increase of their public debt.

(4) Monetary Expansion

Such an additional increase is certain to take place owing to the rearmament race, which is likely to continue for many years at a growing rate. Sooner or later most of the participants in the rearmament race will reach the stage at which they will be unable to continue to finance rearmament by

means of normal borrowing, unless the burden of the existing indebtedness is drastically reduced. Since it is essential that they should be able to continue to borrow, they cannot afford to resort to very drastic forced conversions, and for this reason they will have to resort to the alternative solution of currency depreciation, whether by deliberate action or simply in consequence of the inflationary borrowing which they have to undertake.

Rearmament is by no means the only factor which will make for monetary expansion. The chances are that the monetary policy of most countries will be decidedly expansionary, apart altogether from the necessity of expansion dictated by the requirements of national defence. The cult of monetary scarcity which reigned supreme before the war and again during the period of post-war stability is not very likely to return. Strangely enough, two diametrically opposite political currents will work against the return of that cult and in favour of expansionism for productive purposes. These political currents are Fascism and democracy. In Fascist countries the principle has been adopted that production shall be determined not by the available financial resources in the form of printed scraps of paper and book entries, but by the volume of labour and raw material available. In the past, production had to adjust itself to the limitations of the financial superstructure. In the totalitarian States, production goes ahead and the financial superstructure has to adjust itself to the volume as best it can. In the democratic countries the same principle has not yet been adopted, and owing to lack of economic discipline its adoption is not so easy as in the Fascist States. At the same time, a powerful trend in the same direction undoubtedly exists. One result of the agitations of the supporters of Social Credit and other radical currency reform schemes was that the general public became aware of the extent to which its prosperity depended upon the monetary policy pursued by the Governments. Having realised this, the public is not likely to put up with a restrictionist policy, which was considered a matter of course in the past. In democratic countries throughout the world, pressure will be brought to bear upon the Government to improve the conditions of the masses, partly by pursuing a monetary policy which would enable producers to get all the credit they want for legitimate purposes, and partly by carrying out vast slum clearance and other public works, which could not conveniently be undertaken by private

capital and enterprise. In countries with universal suffrage, Governments can ill afford to resist this pressure, though the extent to which they will yield may vary according to the political party in power. It seems reasonably certain, therefore, that expansionism has come to stay, in Fascist and democratic countries alike.

(5) Further Devaluations Likely

The existence of excessive indebtedness, the necessity to spend on rearmament and the expansionary monetary policies which are likely to be pursued, together with many other factors, all make for a further all-round reduction in the gold value of currencies. In the case of France, such a reduction is likely to take place in the course of this year. In the case of other countries it may not take place for some time. The chances are, however, that in the long run the gold value of the various currencies will be below its present level. This statement would have sounded incredible during the gold scare, when it was fashionable to believe that in the long run the gold value of the currencies would probably be raised rather than lowered. This belief was based on the assumption that the volume of gold stock and current gold output was considerably in excess of requirements. Those who held this view overlooked the existence of the fundamental trend towards expansion, which is likely to absorb the gold surplus in the course of time. The chances are that as a result of rearmament and the other factors mentioned above the present gold surplus will sooner or later be absorbed by a corresponding expansion of the volume of currency and credit. Thus the creation of a fresh gold surplus, through another all-round devaluation and through the stimulus given to gold production by an increase of the currency value of gold, will then be welcomed by most Governments. But it will come whether it is welcome or not. In fact, the chances are that the exchanges will be depreciated in terms of gold not as a matter of deliberate policy in order to obtain the required gold basis for additional expansion, but owing to the *force majeure* arising through the operation of the factors dealt with above.

(6) Rise in Prices during Next Ten Years

Allowing for all these considerations, it is difficult to escape the conclusion that the fundamental trend will make for a material rise in commodity prices in the course of the next

ten years. This trend may be temporarily offset by trade setbacks similar to that experienced during the last quarter of 1937. It may even become reversed as a result of the short-sighted monetary policy pursued by the various Governments. It is conceivable that from time to time some Governments will attempt to put the clock back and revert to a ruthless deflationary policy in defence of their currencies at an untenable level. In the long run their resistance is bound to be swept away, however, by the force of the fundamental trend. Even if the leading Governments can be persuaded during another gold scare to lower the currency value of gold, the deflationary effect of such a move would be only temporary. Rearmament and the trend towards credit expansion will sooner or later compel these Governments to reverse their ill-advised action.

Although a substantial rise in commodity prices in the long run may conceivably be regarded as certain, this does not mean that the world will not experience setbacks even in the absence of any deflationary monetary policy. The ideal solution would be to regulate the rise so that it took place gradually, and thereby to minimise its disturbing effect. Such a regulation would, however, require a degree of official intervention which is impossible under the present system, at any rate in the democratic countries. For this reason the rise will have to take place in spurts, followed by setbacks. Every now and then the speculative anticipation of a future rise will lead to an exaggerated acceleration of the movement, and this again will provoke a sharp reaction. Conceivably some of these reactions which are likely to occur from time to time will be very severe. Thus the fundamental upward trend does not mean everlasting prosperity. It means booms alternating with slumps. The extent of the slumps will, however, be moderated by the working of the underlying upward trend. The pendulum will not be allowed to swing back to its starting-point, for its backward swing will be checked by the fundamental factors making for a rise. Its next upward trend will again be accentuated by these factors.

(7) If——

We have hitherto been assuming that while rearmament expenditure will be maintained or even increased, it will not be increased to the extreme as a result of a major war. If this assumption proves unfounded, and the next ten years bring another world war or European war, the result will be

the extreme exaggeration of the trend making for higher prices and a depreciation of the gold value of the currencies. While on a moderate scale the upward trend is, on balance, a blessing in disguise, on an exaggerated scale it is bound to become a disaster. Such remains of civilisation as survive the next war will be faced with financial ruin in addition to the immense material damages inflicted upon all belligerents by the ruthless methods of modern warfare. It is to be hoped that mankind will be spared this ordeal, and that the all-round growth of prosperity, associated with an expansionary monetary policy, will succeed in disarming the aggressive spirit making for war.

INDEX

Abyssinia, 116, 120, 151, 152, 174, 179, 190, 193
Angas, Major, 36
Atthalin, A., 89
Aubouin, Roger, 306
Auriol, Vincent, 7, 71 *et seq.*, 77, 78, 81, 82, 85, 313
Austria, 17, 19, 156, 170

Baldwin, Earl, 127, 131
Banker, The, 164
Banks:
 Bank for International Settlements, 27, 47, 48, 297, 305, 306
 — of Chosen, 191
 — of England, 30, 39, 40, 63, 74, 121, 123, 155, 182, 287, 304, 307
 — of France, viii, 30, 73, 74, 75, 77, 80, 81, 83, 89, 90, 93, 94, 96, 97, 100, 101, 104, 105, 110, 111, 138, 139, 163, 296, 297, 299, 305
 — of Italy, 150, 156
 — of Japan, 190, 191, 241
 — of Portugal, 230
 — of Spain, 162, 164, 167, 168, 170, 172
 Banque de l'Indo-Chine, 89, 94
 — de Paris et des Pays Bas, 88, 89
 Gold Discount Bank, 306
 Lloyds Bank, 74
 Martins' Bank, 167
 National Bank of Belgium, 230, 262, 264, 265
 National Provincial Bank, 74
 Netherlands Bank, 230
 Reichsbank, 304
 Riksbank, 48
 Swiss National Bank, 230
Barmat Affair, 265
Baudouin, P., 77, 78, 84, 94, 95, 314
Belga, 4, 233, 255, 261 *et seq.*, 269, 322
Belgium, 19, 29, 69, 109, 226, 255, 257, 261 *et seq.*, 298
Blum, Léon, 5, 6, 7, 12, 70, 71, 73, 76, 77, 78, 81, 82, 83 *et seq.*, 92 *et seq.*, 102, 103, 107, 134 *et seq.*, 210, 211, 214, 313
Bonnet, Georges, 12, 77, 92 *et seq.*, 100 *et seq.*, 109, 110, 219, 275, 276, 277, 314
Boothby, Robert, 58
Bouisson, Fernand, 88
Bradbury, Lord, 21
Brand, The Hon. R. H., 46, 50, 51, 242
Brazil, 255, 320

Caillaux, Joseph, 88, 89, 90
Canada, 221, 273
Carmona, General, 302
Cassel, Professor Gustav, 48, 49, 50, 52
Chamberlain, Neville, 4, 7, 12, 59, 127 *et seq.*, 210
Chautemps, Camille, 12, 15, 77, 91, 92 *et seq.*, 102, 103, 134, 138, 219, 276, 277, 278, 296, 299, 314
China, 13, 117, 174, 177, 178, 179 *et seq.*, 187 *et seq.*, 197, 221, 256, 269 *et seq.*, 308, 319
Ciano, Count, 185
Czechoslovakia, 19, 297

Daily Mail, the, 49
Deflation, 18, 19, 21, 22, 188
Degrelle, Léon, 263 *et seq.*
De Man, Henry, 267
Devaluation:
 — of the belga, 262, 267
 — of the dollar, 233, 243 *et seq.*, 250 *et seq.*
 — of the franc, 5, 22, 69, 70, 71, 151

Devaluation—*continued*
— of the Gold Bloc currencies, 25, 151, 197
— of the lira, 151
Post-war —, 19, 20
Dollar:
(Chinese), 180 *et seq.*, 187 *et seq.*
(United States), 4, 14, 29, 35, 63, 69, 86, 115, 229, 231, 233, 234, 236, 237, 238 *et seq.*, 243 *et seq.*, 250 *et seq.*, 289, 293, 315, 322
Douglas, Major, 36
Dow-Jones Service, 199

Echo de Paris, 308
Egypt, 152
Einzig, Paul:
Monetary Reform in Theory and Practice, 269
The Future of Gold, 35
World Finance since 1914, vii
World Finance, 1935–1937, vii, ix, 11, 69, 88, 127
Exchange Equalisation Account, 30, 39, 56–9, 63, 84, 225, 229, 230, 232, 236, 237, 238, 239, 241, 243, 244, 253, 254, 277, 284, 285, 316
Exchange Stabilisation Fund (French), 73, 77, 80, 100, 101, 111, 139, 276, 277, 299, 314

Finaly, Horace, 87–90
Financial News, The, viii, 155
Fisher, Irving, 248
Fisher, Sir Warren, 132
Flandin, Pierre Étienne, 276
Fournier, Pierre, 94
Franc:
(French), viii, 4, 5, 12, 62, 63, 69 *et seq.*, 77 *et seq.*, 83 *et seq.*, 92 *et seq.*, 99 *et seq.*, 107 *et seq.*, 115, 134 *et seq.*, 154, 220, 226, 230, 233, 255, 257, 267, 275 *et seq.*, 296 *et seq.*, 313, 314, 319, 321, 322, 327
(Swiss), 19, 63, 154, 233
France, viii, 5, 6, 7, 12, 15, 19, 26, 27, 29, 31, 50, 69 *et seq.*, 77 *et seq.*, 83 *et seq.*, 92 *et seq.*, 99 *et seq.*, 107 *et seq.*, 116, 118, 134 *et seq.*, 140, 151, 152, 163, 164, 165, 169, 176, 210, 211, 219, 220, 221, 226, 238, 255, 257, 258, 275 *et seq.*, 284, 291, 296 *et seq.*, 305, 306, 313, 314, 315, 321, 324, 327, 329
Franco, General, 136, 137, 152, 161, 165, 166 *et seq.*
Fritsch, General, 309
Funck, Walter, 309

Gamelin, General, 137
Germany, vii, viii, 12, 15, 17, 19, 30, 31, 37, 83, 108, 115, 119, 124, 134, 135, 136, 140 *et seq.*, 152, 153, 166, 170, 171, 174, 185, 186, 187, 191, 192, 220, 221, 284, 288, 297, 298, 300, 302 *et seq.*, 327
Goebbels, Dr. Paul, 302
Goering, Field-Marshal, 149, 302 *et seq.*
Gold:
Abundance of —, 32
De-sterilisation of —, 208
Flight to —, 5, 14, 99, 100, 225 *et seq.*, 232 *et seq.*, 238 *et seq.*, 243, 244, 256, 258, 323
Maldistribution of —, 20, 26, 27, 30, 31
— output, 29, 30, 44, 46, 227, 228, 229, 238, 325, 329
Rehabilitation of —, 8
Shortage of —, 27, 28, 32
Sterilisation of —, 31
Stocks of —, 25, 45, 46, 47, 64, 198, 199, 200, 201, 245, 269, 283 *et seq.*, 326, 329
Gold Bloc, 11, 25, 36, 92, 116, 151, 163, 197, 262
Gold clause, 35
Gold scare, viii, 4, 5, 11, 25, 33 *et seq.*, 42 *et seq.*, 53 *et seq.*, 61 *et seq.*, 115, 117, 197, 198, 202, 204, 221, 225, 226, 229, 232, 239, 243, 246, 253, 314, 317, 323
Gold standard, 31, 35, 36
Great Britain, viii, 4, 5, 6, 7, 12, 18, 19, 20, 21, 28, 30, 31, 34, 55 *et seq.*, 63, 65, 86, 102, 103, 108, 109, 111, 116, 119, 120 *et seq.*, 135, 147, 152, 154, 155, 156, 164, 166, 167, 168, 171, 172, 175, 179, 180, 182 *et seq.*, 189, 191, 194, 197, 198,

202, 204 *et seq.*, 210, 211, 212, 216 *et seq.*, 230, 232 *et seq.*, 238 *et seq.*, 243, 244, 256, 271, 272, 273, 283 *et seq.*, 291, 298, 313 *et seq.*, 321, 322, 324, 327
Greece, 146, 169
Guilder, 19, 63, 233

Hall-Patch, Edmund, 182
Hawtrey, R. G., 51
Hechler, P., 305
Hitler, Adolf, 140, 141, 205, 218, 302 *et seq.*
Holland, 30, 69, 109, 110, 220, 221, 257
Hopkins, Sir Richard, 132
Hungary, 17, 19, 170

India, 152
Inflation, 17, 18, 19, 321
Inskip, Sir Thomas, 219
International floating balances, 10, 32, 37, 243, 251, 252, 253, 287
Italy, vii, viii, 5, 13, 19, 20, 30, 83, 108, 116, 124, 140, 150 *et seq.*, 165, 166, 171, 185, 186, 190, 192, 193, 194, 220, 221, 288, 297, 298

Jacobson, Per, 47
Japan, 13, 117, 174 *et seq.*, 179 *et seq.*, 187 *et seq.*, 197, 221, 256, 324
Jouhaux, Léon, 108, 275

Keynes, J. M., 60, 121
Krona (Swedish), 19
Kung Hsin-Chan, 185, 189

Labeyrie, Émile, 77, 82, 85, 94
Latin Monetary Union, 34
Laval, Pierre, 78, 103, 104, 134, 136, 163, 165
League of Nations, vii, viii, 27, 156, 194
Leith-Ross, Sir Frederick, 44, 180, 182, 183
Le Norcy, F., 183
Libya, 152
Lira, 5, 150 *et seq.*, 174, 322
Low, David, 127

Macmillan Report, 21
Manchukuo, 174 *et seq.*
Mark (Reichsmark), 107, 134, 144, 161, 174
Mexico, 273
Michel, Henri:
France, Prends Garde ! 275, 276, 301
Moreau, Émile, 89
Morgenthau, Henry, 40, 59, 241, 255 *et seq.*, 273
Mussolini, Benito, 150 *et seq.*, 174, 177, 185, 307

National Defence Contribution, 4, 7, 12, 127 *et seq.*, 210, 211
National Defence Loan, 122 *et seq.*, 127, 217, 218
New Statesmen, The, 154
Niemeyer, Sir Otto, 305
Norman, Montagu, 230, 304, 306

Ottawa Agreement, 207

Palestine, 152
Pearson, Prof. Frank, 248
Pertinax, 308
Peseta, 161 *et seq.*, 166, 170, 171
Pittman, Senator Key, 180, 270, 274
Poincaré, Raymond, 322
Poland, 19, 136, 170, 297, 298
Portugal, 255, 302

Quesnay, Pierre, 305

Rae, Miss P. M.:
The £ s. d. of National Defence, 218
Rambouillet declaration, 107, 278
Rearmament, vii, viii, 3, 12, 13, 22, 33, 105, 106, 115 *et seq.*, 127 *et seq.*, 134 *et seq.*, 140 *et seq.*, 150 *et seq.*, 176, 177, 198, 199, 217 *et seq.*, 293, 294, 295, 315, 316, 320 *et seq.*, 325 *et seq.*
Reflation, 4, 6, 21, 22, 33, 208 *et seq.*
Reynaud, Paul, 276, 277, 301
Rist, Charles, 77, 79, 84, 314
Rivera, Primo de, 13, 161
Roosevelt, F. D., 6, 8, 13, 15, 35, 36 *et seq.*, 49, 50, 54, 59, 65, 92, 102, 118, 153, 180, 181,

184, 202, 203, 205, 208 *et seq.*, 216, 229, 244 *et seq.*, 250 *et seq.*, 261, 263, 269, 270, 271, 274, 290 *et seq.*, 323
Rothschild, N. M. & Sons, 232
Roumania, 119, 136, 146, 297, 298
Rueff, Jacques, 77
Rydz-Smigly, Marshal, 297

Salazar, Professor, 302
Sarraut, Albert, 74, 134
Savoy, Prince Eugene of, 119
Schacht, Dr. Hjalmar, 12, 15, 141 *et seq.*, 152, 153, 302 *et seq.*
Silver, 4, 14, 180 *et seq.*, 189, 256, 269 *et seq.*
Simon, Sir John, 58, 59, 285
Skandinaviska Kreditaktiebolaget, 50, 52
Sotelo, Calvo, 161, 162, 163
Soviet Russia, 19, 30, 37, 38, 41, 44, 65, 117, 146, 156, 170, 179, 189, 227, 238, 323
Spaak, Paul, 267, 268
Spain, 13, 19, 34, 102, 137, 152, 161 *et seq.*, 166 *et seq.*, 197, 284, 298, 308, 319
Sprague, Professor O. W. M., 37 *et seq.*, 43, 48, 49
Stabilisation, 19, 20, 313 *et seq.*
Stefani, Alberto de, 185
Sterling, ix, 19, 29, 63, 69, 86, 175, 176, 231, 234, 236, 237, 288, 289, 322
Sterling Bloc, 29, 183, 262
Supreme Court of Washington, 6, 35, 210, 213, 292
Sweden, 34, 35, 48, 49, 220
Switzerland, 29, 30, 69, 103, 109, 110, 239, 240, 257, 298

Theunis, G., 262
Times, The, 46, 51, 60, 102
Trip, Dr. L. G. A., 47, 48, 230
Tripartite Agreement, 86, 87, 236, 239, 253, 313, 314, 324
Turkey, 119, 146, 147

Union of South Africa, 29, 221, 228, 314
United States of America, 5, 6, 7, 8, 13, 14, 19, 26, 27, 30, 34, 35, 38, 39, 40, 43, 44, 53 *et seq.*, 64, 65, 86, 102, 103, 109, 117, 154, 155, 175, 179, 180, 182, 184, 185, 186, 189, 190, 191, 197, 199 *et seq.*, 203, 205, 206, 207, 208 *et seq.*, 216, 219, 221, 229, 234, 243 *et seq.*, 248 *et seq.*, 250 *et seq.*, 261, 283, 284, 288, 289, 290, 313, 314, 315, 320 *et seq.*, 327

Van Zeeland, Paul, 14, 15, 233, 257, 261 *et seq.*, 317, 324

Wallenstein, 119
Wall Street, 5, 7, 8, 13, 27, 33, 34, 109, 155, 199, 200, 205, 206, 209, 212, 213, 216, 219, 250, 251, 252, 255, 284, 290
Warren, Prof. George, 248

Yen, 174 *et seq.*, 183, 187, 190 *et seq.*
Yugoslavia, 119, 136, 146, 147, 297, 298